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RALLY

ENERGY CORP.



2003 ANNUAL REPORT

Rally Energy Corp. ("Rally Energy" or the "Corporation") is a Calgary-based oil and gas exploration, development and production company with active projects in Egypt, Canada and Pakistan. In relation to international opportunities, the Corporation's strategy is to apply Canadian technology and expertise to the task of establishing and expanding commercial production in areas where significant in-place reserves have already been identified.

In Egypt, the Corporation operates the Issaran oilfield under a renewable long term Petroleum Services Agreement covering a 72 square kilometre portion of the Ras Issaran Concession Area held by The General Petroleum Co. S.A.E. The Issaran oilfield is a heavy oil development opportunity with strong production growth potential. Current field production is approximately 2,000 barrels of oil per day.

In Canada, the Corporation's focus is on natural gas exploration at shallow-depths on Prince Edward Island and on low risk development opportunities in Western Canada. On Prince Edward Island, Rally Energy holds working interests, ranging between 80% and 100%, in eight permits covering 708,053 acres. In Western Canada, the Corporation holds working interests ranging between 25% and 60% in five prospects.

In Pakistan, upon completion of the disposition agreement announced on April 20, 2004, Rally Energy will hold a 22.5% partially-carried working interest in the 1,213 square kilometre Safed Koh Block located in the Province of Punjab. The Corporation will be carried for its 22.5% share of up to US\$2.2 million of costs to be expended under a Phase II program of drilling, recompletion and testing activities.

Rally Energy is a Tier One TSX Venture Exchange listed company (Trading Symbol "RAL") that is also listed on the Frankfurt Stock Exchange (Trading Symbol "RLE").

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ANNUAL GENERAL MEETING

Rally Energy invites its shareholders and other interested parties to attend the Corporation's Annual Meeting at 3:00 p.m. on Monday, June 28, 2004 to be held in the Cardium Room at the Calgary Petroleum Club, 319 Fifth Avenue S.W., Calgary, Alberta, T2P 0L5. Shareholders unable to attend are requested to sign and return the proxy form mailed with this report.

All financial information is presented in Canadian funds, unless otherwise noted.

ABBREVIATIONS

bbls	barrels of oil
bbls/d	barrels per day of oil
mbbls	thousands of barrels of oil
mcf	thousand cubic feet of gas
mmcf/d	million cubic feet per day of gas
bcf	billion cubic feet of gas

FINANCIAL & OPERATING HIGHLIGHTS

	Years Ended December 31	
	2003	2002
FINANCIAL (CANADIAN \$)		
Revenue	\$ 11,238,300	\$ 3,497,200
Cash Flow from Operations	\$ 2,402,000	\$ (527,800)
Per Share	\$ 0.04	\$ (0.02)
Net Loss	\$ (5,229,200)	\$ (2,385,100)
Per Share	\$ (0.09)	\$ (0.08)
Capital Expenditures, net	\$ 12,409,600	\$ 8,845,500
Cash	\$ 2,260,400	\$ 1,811,900
Working Capital	\$ 499,300	\$ 208,000
Total Assets	\$ 34,631,500	\$ 29,421,400
Shareholders' Equity	\$ 23,982,900	\$ 23,117,900
Common Shares Equivalents		
Basic	71,389,740	63,411,273
Diluted	85,528,742	69,899,188
OPERATIONS		
Oil Production (bbls/d)*	1,135	724
Average Selling Price (\$/bbl)	\$ 27.13	\$ 27.76
Netback (\$/bbl)	\$ 13.70	\$ 11.22
Reserves - Oil (mbbls)		
Proved	1,448	1,053
Probable	2,561	1,043
Total Proved plus Probable	4,009	2,096

* 2003 Exit rate oil production was approximately 1,800 bbls/d.



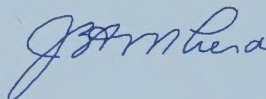
REPORT TO OUR SHAREHOLDERS

2003 was a year in which Rally Energy's operating and financial results showed significant improvement. Production for the year increased 57% to 1,135 bbls/d from 724 bbls/d in 2002. Revenue increased to \$11.2 million, up 221% from \$3.5 million in 2002, and cash flow from operations increased to \$2.4 million compared to a deficiency of \$0.5 million in 2002. In Egypt, Rally Energy drilled five wells in the Issaran field during 2003. Of particular significance was well #25, which penetrated a thick section of Lower Dolomite formation which exhibited excellent porosity and permeability, along with good reservoir pressure. After perforating 141 feet of Lower Dolomite, this well was producing in excess of 800 bbls/d of oil by mid-November 2003. The well has continued to produce at that level through to the current date.

Our most important achievement in 2003 was to accurately define existing and potential oil production areas in the Issaran field. In view of the success with well #25, particular focus was placed on identification of additional Lower Dolomite development opportunities. Our future success in expanding production and increasing our proven reserves is dependent on accurately mapping major faults and identifying existing and potential producing formations within identified fault blocks. At this time, we are confident that we have done this and that our well data, tied into our

reprocessed and interpreted 3-D seismic, establishes that major faults are visible and that existing producing formations can be accurately correlated to predictable positions within identified fault blocks.

During 2004, we will strive to increase production through the pursuit of a more active drilling program than was conducted in 2003. To date in 2004, six new wells have already been drilled. A number of initiatives, described in the body of this annual report, are now being conducted concurrently in the Issaran field. In particular, we are implementing an active primary production drilling program and we have commenced an enhanced thermal recovery pilot project. Management fully expects that these initiatives will achieve solid sustainable production increases in our Issaran oilfield.



John G.F. McLeod, P.Eng.

President and Chief Executive Officer

May 14, 2004



ISSARAN PROJECT, EGYPT

Rally Energy, through its wholly-owned subsidiary Scimitar Production Egypt Ltd. ("Scimitar Production Egypt"), has the exclusive right to operate and develop heavy oil production in a 72 square kilometre portion of the Ras Issaran concession area located on the west shore of the Gulf of Suez. The Corporation's operations area in the Ras Issaran Concession is referred to throughout this report as "Issaran". Under the terms of a long-term Petroleum Service Agreement ("PSA"), executed in 1998, Scimitar Production Egypt is paid a fee based on Issaran oilfield production. During 2003, approximately 80% of Issaran oil production was credited to Scimitar Production Egypt under this fee arrangement. Scimitar Production Egypt's share of Issaran oil is sold to the

Egyptian General Petroleum Company ("EGPC"), a company wholly-owned by the Arab Republic of Egypt. All oil production is currently transported by truck from the Issaran oilfield to the North Amer terminal, 10 kilometres to the south of the field. The North Amer terminal oil is transported by pipeline to Ras Gharib where it is blended with light crude from nearby fields and sold internationally as "Ras Gharib Blend". EGPC currently pays 80% of the Ras Gharib Blend price for Scimitar Production Egypt's share of delivered oil. Ras Gharib Blend pricing during 2003 averaged US\$4.90 per barrel below the posted price of Brent oil.

The rights to exclusively develop and produce heavy oil from the Issaran oilfield were originally acquired by Scimitar



Production Egypt on November 4, 1998 in return for an agreement to commit to an initial three-year pilot phase which could be converted, upon a "Commercial Development Declaration", by a renewable 20-year Commercial Development Period. In October of 2001, based on a "Commercial Development Declaration" and an undertaking to develop the Issaran oilfield, Scimitar Production Egypt earned the rights to the field for a further 19-year development and production period with provisions for two additional five-year extensions. There is no minimum ongoing capital expenditure or minimum work program condition that needs to be satisfied in order to maintain Scimitar Production Egypt's rights for the development and production periods noted above.

ISSARAN OIL PRODUCTION

Rally Energy's Issaran oil production for 2003 averaged 1,133 bbls/d, up substantially from 724 bbls/d averaged in 2002. Fourth quarter 2003 production of 1,648 bbls/d represented a solid increase over the 962 bbls/d average production reported for the nine month period ended September 30, 2003. Production increased at year-end as a result of the drilling programs conducted earlier in 2003, with most of the increase related to production from well #25. December 2003 production averaged 1,654 bbls/d and production continued to increase into the first quarter of 2004, averaging 1,735 bbls/d.

DRILLING, SEISMIC INTERPRETATION AND FIELD ACTIVITIES

Rally Energy drilled five wells during 2003 in the Issaran oilfield. Of particular note was the drilling of the Issaran #25 well which penetrated a 460 foot thick section of the Lower Dolomite formation. The well exhibited excellent porosity and permeability in the Lower Dolomite with good reservoir pressure. By the middle of November the well was producing

over 800 bbls/d from 141 feet of perforated Lower Dolomite section. Well #25 continued to produce at that level through to year-end and into the first quarter of 2004. This well also penetrated a substantial interval of Upper Dolomite that appears oil bearing on log analysis.

Drilling results from 2003 have confirmed that hydrocarbon entrapment in the Issaran field occurs in a series of fault blocks. During 2003, it was recognized that the existing processed 3-D seismic data over the Issaran field was not adequately identifying fault blocks, primarily due to the absence of proper weathering corrections. Therefore the entire 3-D seismic database was completely reprocessed in Canada. The reprocessing was completed by year-end and interpretation is ongoing. The Corporation is now confident that historic well data ties to the reprocessed seismic information, that major faults can now be identified, and that the various producing formations can be correlated to predictable positions within these fault blocks.

The identified fault block in which Issaran well #25 is located is of major importance to the Corporation. The reprocessed 3-D seismic now provides definition as to the extent of this fault block for both Upper and Lower Dolomite development opportunities. Subsequent to year-end, the Issaran #42 well was drilled offsetting well #25. The same Upper Dolomite section as was encountered in well #25 was penetrated while drilling well #42, with substantial free oil hydrocarbons evident in recovered fluids. Because of extensive fracturing and the resultant loss of drilling fluids circulation during the drilling of well #42, only 120 feet at the top of the identified 460 feet of Lower Dolomite gross pay section was penetrated for this well. The top of this Lower Dolomite section in well #42 has now successfully been placed on production at initial pre-cleanup rates in excess of 250 bbls/d.

Both Upper and Lower Dolomite formations in the fault block in which wells 25 and 42 are located have exhibited characteristics of fractured reservoirs which should have economic primary production potential. This is important when considering the Upper Dolomite formation. The Corporation believes it has identified an area where, due to fracturing in this zone, economic primary production can be established. Rally Energy is currently examining modifications to its drilling program in order to penetrate more of the Lower Dolomite fractured pay zone in subsequent wells. Further development of both Upper and Lower Dolomite fractured carbonates will continue through 2004 with separate wells drilled to target each individual formation.

During 2003, the Corporation commenced an assessment of the producing potential of the Zeit Sand, an unconsolidated shallow-depth sand formation. Whereas current producing horizons in the Issaran field are carbonates, portions of the field are overlain at shallow depths with an unconsolidated sand zone up to 30 feet thick, known as Zeit Sand, that contain a 15 degree API gravity crude oil. The Zeit Sand had been observed in several wells but consent had not previously been received from The General Petroleum Co. S.A.E. ("GPC") to production test this zone. In October 2003 preliminary testing of the Zeit Sand in two wells achieved production rates of between 50 and 150 barrels of oil per day per well. Permanent production operations, involving the installation of specialized sand handling pumping systems and sand screens,

commenced in the second quarter of 2004. An extensive Zeit Sand development drilling program has now been proposed to GPC. Application has been made to proceed with drilling of the first three locations in what is currently expected to be an initial 30 well Zeit Sand program.

ENHANCED RECOVERY IN THE DOLOMITES

The Upper Dolomite formation in the Issaran field

contains significant in-place oil accumulations. The currently mapped Issaran Upper Dolomite contains an estimated 300 million barrels of original oil-in-place. A computer reservoir model study for this formation was completed in 2003 and was presented to GPC. This study compared projected Upper Dolomite oil recoveries in three ways: under primary production, under secondary recovery by waterflood, and under secondary thermal recovery. The reservoir model study indicated that while water flooding could increase primary production from a level of less than one percent to a level of up to 3% to 4%, the incremental recovery did not appear to be sufficient to justify the required capital costs. The reservoir model study did, however, indicate that cyclic steam stimulation, followed by steam-drive in the Upper Dolomite formation could result in the recovery of an estimated 24% or more of the original oil-

in-place. The reservoir study confirms that thermal recovery has the potential to significantly increase our Issaran oilfield production on an economic basis.

ISSARAN OPERATIONS



At this time we expect that the Thermal Recovery Project will be undertaken in three phases. Phase I will be a three well field test pilot with one thermal observation well and two injection/production wells. The observation well has already been drilled and cased in preparation for the installation of temperature sensors. It is anticipated that two additional wells will be drilled in the second quarter of this year with cyclic steam stimulation commencing in the third quarter.

Upon successful completion of the Phase I tests, Phase II is expected to be a commercial production pilot program involving the drilling of up to 30 wells commencing in 2005. The Phase III commercialization of the field is expected to be undertaken in stages, over time, and could eventually include the drilling of upwards of 300 shallow wells.

The potential exists for expansion of thermal recovery programs to include Lower Dolomite formations. Recent drilling has identified a new accumulation of Lower Dolomite oil in the southern portion of the Issaran field. To date, four wells have each encountered approximately 225 feet of Lower Dolomite oil saturated porosity. With in-house estimates of an additional 90 million barrels of oil-in-place, the Corporation is examining the feasibility of thermal recovery as a program to maximize productivity from this pool.

PRINCE EDWARD ISLAND

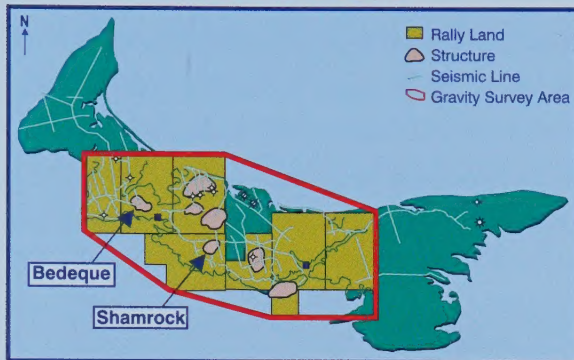
PEI PERMITS

Rally Energy holds working interests of between 80% and 100% in eight oil and gas permits on Prince Edward Island ("PEI") encompassing 708,053 acres. The permits are located primarily onshore PEI within the Magdalen Basin, an under-explored basin by global standards. The working interests in seven of the permits are subject to a 2.5% gross overriding royalty. These seven permits, which include rights to all hydrocarbons without any depth restrictions, will expire during 2004. The eighth permit is renewable annually until 2008. A total of \$2.4 million was expended on PEI programs during 2003.

Rally Energy's technical team has completed an extensive evaluation of existing seismic, geologic and well data. Based on this analysis, management believes the PEI Permits could contain commercial reserves of conventional natural gas with potential for coalbed methane and deep subsalt gas. The Corporation has initially targeted conventional natural gas formations at shallow depths. Rally Energy has identified several structures which could contain valid exploration prospects and has drilled two wells, Irishtown #2 and Seaview #1, each targeting a different shallow-depth natural gas play type.

In the third quarter of 2003, Rally Energy completed an extensive airborne gravity/magnetic survey covering all of Rally's acreage and acquired three new lines of seismic covering 21 kilometres in the Shamrock area. The Corporation currently intends to continue with its PEI activities, however, a full re-evaluation of Rally Energy's PEI strategy is underway.

**PRINCE EDWARD ISLAND
AIRBORNE MODERN GRAVITY
AND MAGNETIC SURVEY**



OVERVIEW OF THE MAGDALEN BASIN

The Magdalen Basin, a sub-basin of the Central Maritimes Basin of Eastern Canada, is one of North America's largest Early to Late Paleozoic basins covering approximately 215,000 square kilometres. The basin is analogous to the Michigan and Black Warrior basins of Northeastern United States that have been successfully explored and developed for gas and oil. The basin tends to be gas prone. The area is characterized by large, broad anticlinal to fault controlled structures due primarily to underlying salt tectonics. The area and formations of interest have been virtually unexplored. Since 1944, only 19 wells have been drilled in the vicinity of PEI, 12 onshore and 7 offshore. In some of these wells, minor to significant gas shows were encountered in the upper formations including Cable Head, Green Gables and Bradelle. The East Point E-49 well drilled offshore northeast of PEI in 1970, tested gas at 5.5 mmcf/d from the Cable Head formation and has estimated gas in place of over 77 bcf. This discovery has been granted Significant Discovery Status.

OPERATIONS

Rally Energy continued to conduct extensive local and regional geological studies. Based on new data received from additional seismic and the gravity/magnetic study Rally Energy

has confirmed a number of large structures which could contain hydrocarbons. These plays have the potential of good to excellent quality reservoir rock (porosity and permeability) at a depth of less than 2,000 meters. The rock is a fluvial deltaic sedimentation characterized by thick, stacked sandstone bodies interbedded with shales which provide good natural source and reservoir seal. The source rocks tend to be gas prone. The area is highly structured with salt type features complimented by major fault movement.

DRILLING

Rally Energy's first PEI exploration well, Irishtown #2, was drilled in the first quarter of 2003. This well targeted a significant regional structural closure along a long normal fault trending northeast/southwest. Excellent reservoir rock was encountered in the Cable Head and Green Gables formations. In the Cable Head, 64 meters of sandstone with good porosity was encountered and, in the Green Gables, 80 meters. Unfortunately, late movement of a small antithetic fault proximal to the main fault is believed to have breached the trap. Gas was trapped deeper in the Bradelle formation which had lower porosity and would therefore not have been economic to produce. The main part of the structure still has the potential for trapping hydrocarbons and could be explored at a later date.

Rally Energy's second exploration well, Seaview #1, was spudded on June 29, 2003 and was cased as a potential gas well. Extensive testing of the well did not yield commercial volumes of natural gas. Work on this well has been suspended pending investigation of potential stimulations to counter possible well bore or reservoir damage which may have affected the ability to properly test the target formations.

WESTERN CANADA

During 2003, Rally Energy acquired working interest positions in several prospective development areas in Alberta and Saskatchewan. In addition, the Corporation participated in one well re-entry and in the drilling of five new oil and gas wells. This participation resulted in two successful oil wells and one gas well. A total of \$1.4 million was expended on Western Canadian programs during 2003.

In the Wauchope area of Saskatchewan, Rally Energy holds a 37.5% non-operated working interest in a Tillston oil well that was drilled and completed in the fourth quarter of 2003. Rally Energy has earned a 37.5% interest in 480 acres of land in this area with this well and has expanded its position to 1,440 acres through land purchases made early in 2004. It is currently anticipated that the drilling of at least one additional well will be conducted during 2004.

In Alberta, Rally Energy participated in a 25% non-operated working interest Sunburst gas well in the Travers area which was tied-in during April of this year and commenced production at a rate of 1.5 mmcf/d. Also in Alberta, Rally Energy, as operator, drilled an oil well in the Provost area of Alberta in November 2003. This well was completed as an oil well but has not yet been placed on production. The Corporation's earn-in commitment was to pay 100% of well costs to earn a 60% working interest in this well and in 320 acres of adjacent lands. It is anticipated that drilling of up to five wells could be undertaken on Rally Energy's holdings in this area.

In the Whiskey Creek area of Alberta, the Corporation acquired a 33% working interest in 560 acres of land. This acreage offsets two significant Mississippian Turner Valley gas discoveries. Geological and geophysical interpretation indicates that there is considerable potential for the discovery play to extend under Rally Energy's acreage. Rally Energy, as operator of the lease, is proceeding with licensing

WESTERN CANADA ACTIVITY



requirements to drill a well that is anticipated to intersect two separate sheets of potential Mississippian gas pay. Drilling on this holding is expected to proceed late in 2004 or early in 2005.

Rally Energy currently intends to participate in low risk Western Canadian drilling opportunities where attractive participation opportunities arise. In addition, selective land acquisitions in high impact discovery areas may be made.

SAFED KOH PROJECT, PAKISTAN

The Safed Koh Block, covering 1,213 square kilometres, was awarded in January 2002. Rally Energy Pakistan Ltd. ("Rally Energy Pakistan"), a wholly-owned subsidiary of the Corporation, currently operates and holds an 80% working interest in this project. The Safed Koh Block is located in the Province of Punjab, immediately south of the Dhodak gas field, Pakistan's largest gas and condensate producing field. The Safed Koh Block includes three large known structures; Rodho, Afiband and Zindapir. The Dhodak Field, with 620 bcf of proven gas reserves and 30 million barrels of condensate is located approximately 16 kilometres north of the Safed Koh Block in a gas bearing area of the Central Indus Basin. The Dhodak Field, and other significant discoveries in the area, indicate that the Safed Koh Block has the potential to produce commercial gas and condensate.



The licence for the Safed Koh Block was granted for an initial two-year term with an option to continue for a third year, provided an exploration well is drilled or an existing well is re-entered and deepened before April 18, 2005. During 2003, Rally Energy Pakistan completed the geological and geophysical studies required to fully satisfy the Safed Koh Phase I Work Program. This resulted in the full release of a US\$553,000 cash collateralized bank guarantee held by the Government of Pakistan.

On April 20, 2004, Rally Energy announced a partial disposition agreement with Dewan Mushtaq Group of Pakistan. This partial disposition will permit Rally Energy to continue to participate in the Safed Koh Block with a reduced working interest of 22.5% and coverage of its share of up to US\$2.2 million of Phase II expenditures. The material terms of this agreement, currently expected to close by June 1, 2004, are as follows:

- ☐ Rally Energy's wholly-owned subsidiary Rally Energy Pakistan, currently the holder of an 80% working interest in the Safed Koh Block, will transfer a 22.5% working interest in the Block to a new wholly-owned Rally Energy subsidiary, Rally Energy Safed Koh Ltd. ("Rally Safed Koh");
- ☐ Rally Energy Pakistan, holding the remaining 57.5% interest in the Block, will be sold to the Dewan Mushtaq Group through a designated affiliate;
- ☐ Dewan will assume operatorship of the Safed Koh Block; and
- ☐ Dewan will carry Rally Safed Koh's 22.5% working interest share of the costs of the Block's Phase II operations consisting of a committed minimum work program for the re-entry and deepening of Rodho Well No. 3 and an optional work program involving the recompletion and testing of Rodho Well No. 2, for a potential maximum aggregate expenditure of US\$2.2 million.

Upon completion of the disposition agreement, Rally Energy will, through its subsidiary, hold a 22.5% working interest in the 1,213 square kilometre Safed Koh Block, with coverage of its share of up to US\$2.2 million of expenditures related to Phase II program drilling, recompletion and testing activities.

MANAGEMENT'S DISCUSSION AND ANALYSIS ("MD&A")

FOR THE YEAR ENDED DECEMBER 31, 2003

This discussion and analysis outlines management's assessment of the consolidated financial and operating results of Rally Energy Corp. ("Rally Energy" or the "Corporation") and its subsidiaries, including its future opportunities and risks, and should be read in conjunction with the audited financial statements and related notes for the year ended December 31, 2003. Rally Energy acquired Scimitar Hydrocarbons Corporation ("Scimitar") on July 10, 2002. The mid-2002 timing of this acquisition materially impacts on the comparability of results between 2003 and 2002. Additional information regarding the Corporation, including our Annual Information Form ("AIF"), can be found at www.sedar.com and www.rallyenergy.com.

The financial information contained herein has been prepared in accordance with Canadian Generally Accepted Accounting Principles ("GAAP"). Unless otherwise indicated, all dollar amounts in this report are in thousands of Canadian dollars. This MD&A is dated May 14, 2004.

Forward Looking Statements

This disclosure contains certain forward looking statements that involve substantial known and unknown risks and uncertainties, including the impact of general economic conditions in all the jurisdictions in which the Corporation operates, changes in industry conditions, changes in laws and regulations including the adoption of new environmental laws, increased competition, the lack of availability of qualified personnel or management, fluctuations in foreign exchange or interest rates, stock market volatility and the Corporation's on-going ability to obtain financing for its operations. Rally Energy's actual results, performance or achievement could differ materially from those expressed in or implied by these forward looking statements and, accordingly, no assurance can be given that any of the events anticipated will transpire or occur, or that benefits, including the amount of revenues or proceeds, will be derived therefrom. These factors, many of which are outside the control of the Corporation, are discussed further in the "Business Risks and Uncertainties" section of the MD&A.

VISION, CORE BUSINESS AND STRATEGY

Rally Energy is a Calgary-based oil and gas exploration, development and production company with core oil production operations in Egypt. Exploration and development activities are also conducted on Prince Edward Island ("PEI"), in Western Canada and in Pakistan. The Corporation's international strategy is to enhance value in areas where discovered reserves already exist by applying Canadian development techniques and technology to the production of reserves.

Our primary property, the Issaran oilfield in Egypt, accounts for substantially all of the Corporation's revenues and has a large prospective inventory of additional well locations. A wholly-owned subsidiary of the Corporation entered into a Petroleum Service Agreement ("PSA") with The General Petroleum Co., S.A.E. ("GPC"), effective November 4, 1998, pursuant to which the Corporation is granted the exclusive right to develop and produce heavy oil from a 72 square kilometre portion of the Ras Issaran concession area located on the west shore of the Gulf of Suez. On October 18, 2001, the Corporation entered the Commercial Development Period of the PSA, after having successfully satisfied the terms of the three-year Piloting Period. The Corporation has the option to extend the 20-year term of the PSA (commencing from November 4, 1998), for up to two additional five-year terms subject to concurrence with the GPC. The Commercial Development Period does not require any specific capital expenditure commitments. The revenue sharing arrangement in the PSA, takes into account a recovery factor for the Corporation's capital, operating and administrative costs. All capital assets purchased in respect

of the Issaran field, and recognized as capital cost in the recovery factor, revert to the GPC on an annual basis. Additional details of the PSA are disclosed in Note 10(d) of the consolidated financial statements and the AIF. Rally Energy has established field and administration offices in Egypt, staffed mostly by Egyptian nationals, to manage and operate the Issaran oilfield. Expatriate personnel provide management and technical expertise to support planning, drilling and general operating activities. Additionally, the Corporation recognizes the importance of maintaining strong relationships with Egyptian authorities to resolve any operational or business issues as they may arise within the political regime.

In Pakistan, Rally Energy, through a wholly-owned subsidiary, is party to a Concession Agreement, covering the 1,213 square kilometre Safed Koh Block, with the Pakistan Government. A partial disposition agreement was recently executed (see Note 10(e) in the consolidated financial statements). The effect of this transaction is that the Corporation will hold a 22.5% working interest that is to be carried for its share of up to the US\$2.2 million project expenditure commitment. Although Pakistan government approvals for this transaction are expected, at this time there are no assurances that the closing will occur. Management has made a determination that the value of the Pakistan property should be accounted for as an impaired asset. Rally Energy does not currently expect to incur any additional ongoing capital costs after the closing of this transaction.

ANNUAL COMPARATIVE SUMMARY

	2003	2002	2001
	(thousands of dollars, unless otherwise stated)		
Revenue	\$ 11,238	\$ 3,497	\$ 370
Cash Flow from Operations	\$ 2,402	(\$528)	(\$177)
<i>Per share - basic</i>	<i>\$0.04</i>	<i>(\$0.02)</i>	<i>(\$0.01)</i>
Loss	\$ 5,229	\$ 2,385	\$ 203
<i>Per share - basic</i>	<i>\$0.09</i>	<i>\$0.08</i>	<i>\$0.02</i>
Total Assets	\$ 34,631	\$ 29,421	\$ 4,692
Convertible Debentures	\$ 6,000	\$ 450	—

No dividends have been declared by the Corporation.

OVERALL 2003 PERFORMANCE

EGYPT

- ☐ production increase to 1,133 bbls/d in 2003;
- ☐ cash flow increases with large fourth quarter production gains;
- ☐ reserves increases;
- ☐ drilling of five Issaran wells; and
- ☐ 3-D seismic analysis and mapping.

PEI

- ☐ drilled two exploratory wells;
- ☐ completed additional seismic; and
- ☐ completed extensive airborne gravity/magnetic survey.

WESTERN CANADA

- ☐ drilled five wells and one re-entry;
- ☐ production commenced late in 2003;
- ☐ identified additional low-risk drilling opportunities; and
- ☐ established a land base.

PAKISTAN

- ☐ completion of US\$553,000 work commitment;
- ☐ election to proceed to Phase II made in early 2004; and
- ☐ partial disposition in 2004 may reduce working interest to 22.5%.

EQUITY

- ☐ \$6.0 million of convertible debentures;
- ☐ \$2.5 million common share private placement;
- ☐ \$2.7 million flow-through share private placement; and
- ☐ \$0.3 million from exercise of options.

Revenue has increased as a result of the mid-2002 corporate acquisition that resulted in Rally Energy operating the Issaran oilfield in Egypt. Prior to the acquisition, the Corporation held petroleum and natural gas properties with minimal production in Western Canada that were disposed of in 2001. In 2003, petroleum and natural gas revenue of \$39,000 (2002 - \$14,000; 2001 - \$370,000) was derived from the Corporation's Western Canadian properties. The currently-owned Western Canadian properties are considered to be non-core holdings and subsequent dispositions may occur without any tax liability due to the large tax pools available to the Corporation.

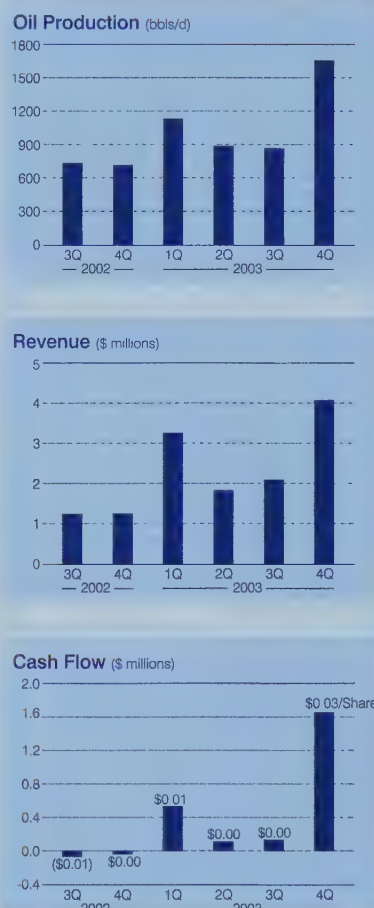
CASH FLOW FROM OPERATIONS

For the year ended December 31, 2003, Rally Energy's cash flow from operations increased to \$2.4 million (\$0.04/share) from a deficiency of \$528,000 (\$0.02/share) for the comparable 2002 period. Cash flow from operations increased to \$1.6 million (\$0.03/share) in the fourth quarter as a result of production increases in a strong oil pricing period. For the fourth quarter of 2002, the Corporation recorded negative cash flow of \$37,000 (\$nil/share).

Cash flow from operations ("Cash Flow"), representing cash generated from operating activities before changes in non-cash working capital items, is a non-GAAP measure. Management utilizes Cash Flow as a key measure to assess the ability of the Corporation to finance operating activities and

capital expenditures. Additionally, Cash Flow has been described and presented in order to provide shareholders and potential investors with information regarding the Corporation's liquidity and its ability to generate funds to finance its operations. This performance indicator may not be comparable to similar measures used by other companies.

PRODUCTION, REVENUE AND CASH FLOW GROWTH



NET LOSS

The net loss for 2003 was \$5.2 million (\$0.09/share) compared to a net loss of \$2.4 million (\$0.08/share) for 2002. For the 2003 fourth quarter, the reported loss was \$1.8 million (\$0.03/share) of which \$1.2 million represented the write-down of the Pakistan petroleum and natural gas holdings due to uncertainties related to the closing of an announced disposition of 57.5% of the Corporation's working interest in the Safed Koh Block. Under the terms of the announced disposition, Rally Energy, through a wholly-owned subsidiary, retains a 22.5% partially carried working interest in this concession but has chosen to completely write-off the historic investment expenditures as an impaired asset. Future Pakistan revenues are contingent on: (i) closing of this transaction after receiving the necessary approvals from the Pakistan government; (ii) confirmation of commercial viability through Phase II activities; and (iii) construction of gathering infrastructure to deliver produced natural gas and liquids. For the fourth quarter of 2002, Rally Energy reported a loss of \$1.3 million (\$0.04/share).

SUMMARY OF QUARTERLY RESULTS

	2003				2002			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
(thousands of dollars, unless otherwise stated)								
Revenue	\$ 3,239	\$ 1,837	\$ 2,086	\$ 4,076	\$ 2	\$ 5	\$ 1,658	\$ 1,832
Cash Flow from Operations	\$ 535	\$ 106	\$ 126	\$ 1,635	\$ (146)	\$ (278)	\$ (67)	\$ (37)
<i>Per share – basic</i>	<i>\$0.01</i>	<i>\$0.00</i>	<i>\$0.00</i>	<i>\$0.03</i>	<i>\$(0.01)</i>	<i>\$(0.01)</i>	<i>\$(0.00)</i>	<i>\$(0.00)</i>
Loss	\$ 914	\$ 1,208	\$ 1,259	\$ 1,848	\$ 149	\$ 279	\$ 655	\$ 1,302
<i>Per share – basic</i>	<i>\$0.02</i>	<i>\$0.02</i>	<i>\$0.02</i>	<i>\$0.03</i>	<i>\$0.01</i>	<i>\$0.01</i>	<i>\$0.02</i>	<i>\$0.04</i>

Quarterly revenue trends are impacted by oil production levels and commodity prices. During the second and third quarters of 2003, oil production from the Issaran oilfield was lower due to natural field declines, a delay until the third quarter in commencement of new drilling and resulting delays in bringing on new production. Oil production levels are impacted by the Corporation's ability to drill new wells and optimize existing production on an ongoing basis. To date in 2004, production has continued at a level higher than that recorded in the fourth quarter of 2003. Quarterly earnings (losses) are also impacted by fluctuations in depletion charges based on reserve report updates, which have historically only been updated at year-end, and operating expense accrual variances. In the fourth quarter of 2003, the Corporation recorded a \$1.2 million write-down for the total cost of its Pakistan gas exploration properties.

PRODUCTION, REVENUE AND NETBACK

(thousands of dollars, unless otherwise stated)

	2003									
	First Quarter		Second Quarter		Third Quarter		Fourth Quarter		Year	
<i>Oil production (bbls/d)</i>	1,129		896		865		1,648*		1,135*	
	<i>\$/bbl</i>		<i>\$/bbl</i>		<i>\$/bbl</i>		<i>\$/bbl</i>		<i>\$/bbl</i>	
Oil revenue, gross	\$3,239	\$31.88	\$1,837	\$22.53	\$2,086	\$26.22	\$4,076	\$26.89	\$11,238	\$27.13
Royalties and related credits	(675)	(6.65)	(407)	(4.99)	(469)	(5.90)	(789)	(5.21)	(2,340)	(5.65)
Operating expenses	(1,253)	(12.34)	(702)	(8.61)	(697)	(8.76)	(573)	(3.78)	(3,225)	(7.78)
Netback from Operations	\$1,311	\$12.89	\$ 728	\$ 8.93	\$ 920	\$11.56	\$2,714	\$17.90	\$ 5,673	\$13.70

*includes minor production from Western Canadian properties

	2002									
	First Quarter		Second Quarter		Third Quarter		Fourth Quarter		Year	
<i>Oil production (bbls/d)</i>	n/a		n/a		731		710		724	
	<i>\$/bbl</i>		<i>\$/bbl</i>		<i>\$/bbl</i>		<i>\$/bbl</i>		<i>\$/bbl</i>	
Oil revenue, gross	\$ 2		\$ 5		\$1,658	\$27.32	\$1,832	\$28.05	\$3,497	\$27.76
Royalties and related credits	–		–		(431)	(7.11)	(494)	(7.56)	(925)	(7.34)
Operating expenses	–		–		(474)	(7.80)	(686)	(10.51)	(1,160)	(9.20)
Netback from Operations	\$ 2		\$ 5		\$ 753	\$12.41	\$ 652	\$ 9.98	\$1,412	\$11.22

Average oil production for the year ended December 31, 2003 was 1,135 bbls/d, as compared to 724 bbls/d during 2002. Gross revenue from oil sales for 2003 was \$11.2 million (\$27.13/bbl), before royalties and related credits. For the year ended December 31, 2002, Rally Energy reported gross revenue of \$3.5 million (\$27.76/bbl), primarily reflecting results from operations subsequent to the acquisition of Scimitar on July 10, 2002. New wells drilled in the Issaran field during the third quarter of 2003, resulted in fourth quarter 2003 production averaging 1,648 bbls/d, a significant increase from 865 bbls/d reported for the third quarter of 2003. The increased production, along with slightly higher oil prices in the fourth quarter of 2003 resulted in gross revenue of \$4.1 million (\$26.89/bbl) for the quarter, as compared to \$2.1 million (\$26.22/bbl) in the third quarter of 2003. For the fourth quarter of 2002, oil production was 724 bbls/d and revenue was \$1.8 million (\$28.05/bbl). The majority of the revenues reported are from the Issaran oilfield in Egypt. The Canadian revenue included therein is immaterial.

Netback from operations represents the funds available after satisfying all royalty burdens and operating costs. For 2003, Rally Energy's netback was \$5.7 million (\$13.70/bbl), representing 50% of gross revenue. This increased from the 2002 netback of \$1.4 million (\$11.22/bbl), representing 40% of gross revenue. The netback for the fourth quarter of 2003 was \$2.7 million (\$17.90/bbl), an increase from \$652,000 (\$9.98/bbl) for the corresponding 2002 fourth quarter. Netbacks are affected by oil pricing, however the 2003 netback increases are primarily related to economies of scale realized from oil production increases without proportional operating expense increases, and the lower GPC production fee attributable to oil production from new wells. Netback from operations in the fourth quarter of 2003 was \$17.90/bbl compared to \$12.89/bbl in the first quarter of 2003 even though realized oil prices were less in the fourth quarter (\$26.89/bbl) than in the first quarter (\$31.88/bbl).

PRODUCTION FEES

Under the terms of the Issaran oilfield PSA, as amended, 15% of new oil well production and 45% of production from old oil wells is credited to the account of the GPC. This payment satisfies the Corporation's entire tax liability for Issaran oil production in Egypt. For the year ended December 31, 2003, GPC payments totaled \$2.2 million (\$5.35/bbl), representing 20% of gross revenue. For the corresponding 2002 period, the GPC payments were \$801,000 (\$6.36/bbl), representing 24% of gross revenue. Pursuant to the terms of certain marketing agreements, marketing fees, linked to realized oil prices and production, of \$174,000 (\$0.42/bbl) were paid during 2003. In 2002, marketing fees were \$45,000 (\$0.35/bbl).

On a quarterly basis, royalties and related credits were \$789,000 (19% of revenue) for the fourth quarter of 2003 as compared to \$494,000 (27% of revenue) in the fourth quarter of 2002. During the fourth quarter of 2003, increased oil production from new wells in the Issaran field, which carries the above noted 15% burden, resulted in a reduction in production fees on a percent-of-revenue basis.

OPERATING EXPENSES

Operating expenses for 2003 were \$3.2 million (\$7.78/bbl) as compared to \$1.2 million (\$9.20/bbl) for 2002. Higher oil production during the fourth quarter of 2003 has contributed to lower operating costs per barrel of oil produced since approximately 48% of the operating expenses are fixed. For the year ended December 31, 2003, operating expenses represent 29% of gross revenue as compared to 33% for the prior year.

For the fourth quarter of 2003, operating expenses were \$879,000 (\$5.80/bbl; 22% of revenue) before a prior period capitalization adjustment of \$306,000 as compared to \$686,000 (\$10.51/bbl, 37% of revenue) for the corresponding

2002 quarter. In part, this reduction reflects how, on a per-unit basis, higher oil production lowers per-unit costs as the increased production can be accommodated within our existing fixed cost structure. A review of 2003 workover operations during the fourth quarter determined that certain projects expensed earlier in 2003 should have been capitalized. The revision was approximately \$306,000. After the capitalization adjustment, the reported operating cost in the fourth quarter of 2003 was \$573,000 (\$3.78/bbl, 14% of revenue).

GENERAL AND ADMINISTRATIVE EXPENSES

(thousands of dollars, unless otherwise stated)

	2003			
	Egypt	Canada	Pakistan	Total
General and administrative expenses:				
Gross	\$ 1,027	\$ 2,229	\$ 557	\$ 3,813
Capitalized	—	(345)	(427)	(772)
Net	\$ 1,027	\$ 1,884	\$ 130	\$ 3,041
<i>Per barrel</i>	\$2.48	\$4.55	\$0.31	\$7.34

	2002			
	Egypt	Canada	Pakistan	Total
General and administrative expenses:				
Gross	\$ 799	\$ 1,351	\$ 439	\$ 2,589
Capitalized	—	(297)	(329)	(626)
Net	\$ 799	\$ 1,054	\$ 110	\$ 1,963
<i>Per barrel</i>	\$6.34	\$8.37	\$0.87	\$15.58

Consolidated general and administrative expenses were \$3.0 million for 2003 as compared to \$2.0 million for 2002, with the increase primarily due to increased corporate activity and additions to the technical staff of the Corporation. Rally Energy capitalizes those portions of general and administrative expenses that relate to exploration projects in PEI and Pakistan. Currently, all general and administrative costs related to Egypt are associated with development activities and, accordingly, to date none have been capitalized. During 2003, \$772,000 (20%) of general and administrative costs were capitalized. For the comparative 2002 period, the Corporation capitalized \$626,000 (24%) of general and administrative costs.

INTEREST AND FINANCE CHARGES

(thousands of dollars, unless otherwise stated)

	2003	2002
Interest expense	\$ 502	\$ 50
Accretion expense on debentures	78	—
Amortization of deferred charge	78	—
Total expense	658	50
Interest income	92	36
Gain on foreign exchange	92	—
Total income	184	36
Net expense	\$ 474	\$ 14
<i>Per barrel</i>	\$1.14	\$0.12

Total interest and finance charges increased to \$658,000 during 2003 from \$50,231 in 2002 as a result of the \$6.0 million, 12% unsecured convertible debentures that were issued on June 13, 2003. During 2002, the Corporation had convertible debentures of only \$450,000. Included in the 2003 amount is \$155,615 of non-cash charges pertaining to the issue of convertible debentures. Additional details are disclosed in Note 6 of the consolidated financial statements.

In the normal course of business, the Corporation earned interest from invested funds and recorded a foreign exchange gain during 2003 and 2002.

DEPLETION AND DEPRECIATION

(thousands of dollars, unless otherwise stated)

	2003	2002
Depletion, depreciation and amortization	\$ 6,078	\$ 1,820
Future site restoration amortization	66	—
Total	\$ 6,144	\$ 1,820
Per barrel	\$14.83	\$14.45

Total depletion and depreciation charges for 2003 were \$6.1 million, of which depletion pertaining to producing properties in Egypt represented \$5.7 million. The remainder represents fixed asset depreciation. No depletion has been calculated on Canadian projects as they are still in the pre-production stage. Depletion and depreciation charges for 2002 were \$1.8 million.

During 2003, the depletion rate increased slightly to \$13.72/bbl from \$13.32/bbl in 2002 as a result of higher costs related to future capital requirements. Depletion expense in 2003 has been determined using the unit-of-production method based on a year-end reserves balance of 1.4 million barrels of proved reserves at December 31, 2003 (1.1 million at December 31, 2002), as evaluated by DeGolyer and MacNaughton Canada Limited, an independent reservoir evaluation firm. On a per-unit basis, we expect a lower depletion rate in 2004 as a result of new drilling that should re-categorize the higher level of probable reserves assessed at December 31, 2003, to proved status during 2004.

With respect to the Pakistan properties, Rally Energy recently announced that it will reduce its holdings to a partially carried position (22.5% working interest) and has not committed any additional capital to the project at this time. Management has determined that it is prudent to write-down

the existing \$1.2 million investment in Pakistan due primarily to uncertainties related to the announced disposition of 57.5% of the Corporation's existing working interest position.

CAPITAL EXPENDITURES

In 2003, Rally Energy drilled five wells (five net wells) in Egypt and participated in the drilling of seven wells (4.4 net wells) in Canada. The Corporation also participated in one well re-entry (0.5 net) in Canada and in significant workover operations in Egypt. Capital expenditures totaled \$12.4 million during 2003, up from \$8.8 million in 2002.

(thousands of dollars)	2003	2002
Egypt		
Drill, complete and workovers	\$ 6,127	\$ 2,658
Seismic, evaluation and other	818	850
Inventory (casing)	799	—
Capitalized admin. costs	—	—
Total	\$ 7,744	\$ 3,508
Canada		
Drill and complete	\$ 2,915	\$ 233
Seismic, evaluation and other	912	852
Lease acquisition	—	1,799
Corporate acquisition	—	1,602
Capitalized admin. costs	345	297
Total	\$ 4,172	\$ 4,783
Pakistan		
Seismic, evaluation and other	\$ 67	\$ 225
Capitalized admin. costs	427	329
Total	\$ 494	\$ 554
Grand Total		
Drill, complete and workovers	\$ 9,042	\$ 2,891
Seismic, evaluation and other	1,797	1,927
Lease acquisition	—	1,799
Corporate acquisition	—	1,602
Inventory (casing)	799	—
Capitalized admin. costs	772	626
Total	\$ 12,410	\$ 8,845

In Egypt, five wells were drilled and major workover operations were conducted. These activities have resulted in increased production and the discovery of new reserves and new producing horizons. In preparation for further drilling in Egypt, Rally Energy has purchased casing and tubing

inventory. At December 31, 2003, \$1.1 million of the cost of this inventory has been recorded in property, plant and equipment since it is intended to be used in future drilling programs.

On PEI, Rally Energy drilled, completed and tested its second exploration well (Seaview #1), however, the results did not yield commercial indications of natural gas and the well has been suspended. During the third quarter, additional seismic was shot on PEI, and an extensive high resolution airborne gravity/magnetic survey was conducted over Rally Energy's permits at a cost of \$550,300. The Corporation currently intends to continue with its PEI activities, however, a full re-evaluation of its PEI strategy is underway.

LIQUIDITY AND CAPITAL RESOURCES

At December 31, 2003, Rally Energy had a cash position of \$2.3 million, as compared to \$1.8 million at December 31, 2002. Working capital at December 31, 2003 increased to \$499,000, an increase from working capital of \$208,000 at December 31, 2002. Capital expenditures during the fourth quarter resulted in a high level of accounts payable at year-end.

At December 31, 2003, Rally Energy has accrued \$398,500 on account of interest expenses, primarily related to the \$6.0 million, 12% unsecured convertible debentures that were issued on June 13, 2003 and require semi-annual interest payments (January and July). During 2003, Rally Energy completed a \$2.7 million flow-through equity offering in December, a \$2.5 million common share private placement in June and share issuance proceeds of \$266,000 resulted from exercise of an aggregate of 600,000 common share options at an average price of \$0.44 per share. Additionally \$450,000 of 12% convertible subordinated debentures issued in July 2002 were converted into 584,415 common shares on January 22, 2003 at a conversion price of \$0.77 per share.

In June 2003, the Corporation issued \$6.0 million of 12% unsecured convertible subordinated debentures that mature on July 1, 2006. The debentures are convertible, at the option of the holder, into common shares at a conversion price of \$1.00 per common share (\$1.10 per common share subsequent to July 1, 2005). The Corporation may redeem the debentures at any time after December 31, 2004 at par, in whole or in part, if the closing price of the Corporation's common shares is at or above \$2.00 for 30 consecutive days.

Rally Energy expects to generate sufficient cash flow from operations to meet its ongoing commitments. In addition to internally generated sources, additional funds may be required from time-to-time to fund development activities. General market conditions in effect at the time could impact on the Corporation's ability to raise additional funds either in equity or debt form.

On April 30, 2004, the Company, through its wholly-owned subsidiary, Scimitar Production International Ltd., closed a US\$3.0 million unsecured project investment financing to fund further development of the Issaran oilfield. Under the terms of the Investment Agreement, the investor, Gemini Oil & Gas Limited, an independent international oil and gas investment fund, is entitled to revenue-based payments from the Issaran oilfield commencing in 2005. The maximum revenue-based entitlement will be US\$1.5 million in each of 2005 and 2006 with no minimum payments required. Upon investment payout, and continuing until December 31, 2012, the investor is entitled to receive 2.6% of the Corporation's Issaran oil revenues, derived from a maximum of 7,000 bbls/d of production, net of marketing fees and entitlements of the GPC.

RESERVES

At December 31, 2003, Rally Energy's reserves were evaluated by the independent engineering firm of DeGolyer and MacNaughton Canada Limited (formerly Outtrim Szabo Associates Ltd). During the year, the Corporation drilled twelve wells (9.4 net wells) (five at the Issaran oilfield in Egypt and seven in Canada) and participated in one well re-entry in Canada. The drilling program resulted in significant reserve additions, as compared to last year:

Reserves Reconciliation

(company interest reserves before royalties, barrels of oil equivalent)

	Proved Producing	Total Proved	Total Proved & Probable
Egypt			
Opening balance	809,240	1,053,075	2,096,039
Additions/revisions	702,375	776,665	2,265,209
Production	(413,561)	(413,561)	(413,561)
Closing balance	1,098,054	1,416,179	3,947,687
Canada			
Opening balance	—	—	—
Additions	5,993	31,805	62,215
Production	(688)	—	(688)
Closing balance	5,305	31,805	61,527

Net Present Value at 10%

(thousands of dollars)

	Proved Producing	Total Proved	Total Proved & Probable
At December 31, 2003			
Egypt *	\$ 10,642	\$ 11,388	\$ 29,763
Canada	177	611	864
Total	\$ 10,819	\$ 11,999	\$ 30,657
At December 31, 2002:			
Egypt	\$ 8,601	\$ 10,276	\$ 18,901
Canada	—	—	—
Total	\$ 8,601	\$ 10,276	\$ 18,901

* Net of future development capital expenditures of \$1.6 million.

The valuation associated with these reserves and the finding costs, on both a Proved and Proved plus Probable basis, are summarized below:

Finding & Development Costs

(thousands of dollars, unless otherwise stated)

	2003 Capital Expenditures	Change In Future Capital	Total Capital	Reserve Additions (bbbls)	Finding & Development Cost (\$/bbl)
Egypt					
Proved reserves	\$ 6,821	\$ 1,095	\$ 7,916	776,665	\$ 10.19
Proved & probable	\$ 6,821	\$ 702	\$ 7,523	2,265,209	\$ 3.32
Canada					
Proved reserves	\$ 1,362	\$ 24	\$ 1,386	31,805	\$ 43.58
Proved & probable	\$ 1,362	\$ 24	\$ 1,386	62,215	\$ 22.28

BUSINESS RISKS AND UNCERTAINTIES

Rally Energy is in the business of exploring for, developing and producing oil and natural gas. The Corporation has production operations in Egypt and Canada. Along with the competitive nature of the oil and gas industry, risk exposures, some of which are beyond the control of the Corporation, can be categorized as operational, political, regulatory, environmental and financial.

The long-term commercial success of Rally Energy depends on its ability to find, acquire, develop and commercially produce oil and natural gas reserves. Oil and natural gas exploration involves a high degree of risk and there is no assurance that expenditures made on future exploration by the Corporation will result in new discoveries of oil or natural gas in commercial quantities. It is difficult to project the costs of implementing an exploratory drilling program due to the inherent uncertainties of drilling in unknown formations, the costs associated with encountering various drilling conditions and changes in drilling plans and locations as a result of prior exploratory wells or additional seismic data and interpretations thereof.

The process of evaluating prospects and estimating oil and natural gas reserves is complex and subject to uncertainty. Actual operating results, including production performance, may vary from those estimated, possibly materially. Rally Energy manages these risks by having operational control and working interests commensurate with the assessed risk in each project and by hiring qualified professionals, including independent reserves engineers, with appropriate industry experience. The Corporation focuses the majority of its activities on exploitation of existing reservoirs.

Some of the Corporation's operations and related assets are located in countries which carry a higher degree of political and economic risk. Rally Energy's management has considerable expertise operating internationally and has developed solid, long-term relationships within each of the jurisdictions in which it operates. The Corporation adheres to all governmental and environmental regulations as they apply in each operating jurisdiction. Regulation changes could increase costs of the Corporation's operations.

Rally Energy's production base is heavily weighted to heavy oil produced in Egypt which is subject to pricing based on international oil price fluctuations. Oil and natural gas are commodities whose prices have fluctuated widely in recent years and are determined based on world demand, supply and other factors, all of which are beyond the control of the Corporation.

Rally Energy maintains an insurance program which is consistent with industry practice to provide adequate coverage of drilling, operations, safety and the environment.

SENSITIVITIES

The Corporation's cash flow is sensitive to changes in production, commodity prices and currency exchange rates. The expected annual impact, based on the 2003 fourth quarter information, is:

(thousands of dollars, unless otherwise stated)

	Variance in Cash Flow	Variance in Cash Flow per share
Oil Price (a)	\$ 846	\$0.0142
Oil Production (b)	\$ 877	\$0.0147
Foreign Currency (c)	\$ 69	\$ 0.0012

(a) change of US\$1 per barrel

(b) change of 100 bbls/d

(c) \$0.01 change in Cdn\$ in relation to US\$

CONTRACTUAL OBLIGATIONS

(thousands of dollars)

	Payments Due by Period				
	< 1 Year	1-3 Years	4-5 Years	After 5 Years	Total
Flow-through share obligations ¹	2,368	—	—	—	2,367
Convertible debentures ²	—	6,000	—	—	6,000
Office lease ³	108	216	—	—	324
Future site restoration ³	—	—	—	66	66

¹ See note 7 to the consolidated financial statements.

² See note 6 to the consolidated financial statements.

³ See note 10 to the consolidated financial statements.

OFF BALANCE SHEET ITEMS

There are no off balance sheet assets or liabilities.

RELATED PARTY TRANSACTIONS

Transactions between the Corporation and related parties occurred during the year, as disclosed in Note 8 to the consolidated financial statements. During 2003, the Corporation paid \$1.1 million as consulting fees to related parties. All such transactions were in respect of technical and specialized services rendered in the normal course of business operations and represent consideration established and agreed to by the related parties which is similar to those negotiated with third parties. Certain of the payments relate to services provided on an as-needed basis; ongoing contractual commitments with related parties are currently \$35,000 per month. At December 31, 2003, the Corporation has recorded share purchase loans totaling \$100,000 representing funds advanced to certain directors and officers in 2002. Two officers of the Corporation purchased \$42,000 of the June 2003 unit offering.

CRITICAL ACCOUNTING ESTIMATES

Rally Energy's significant accounting policies are disclosed in Note 2 to the consolidated financial statements. Certain accounting policies require that management make appropriate decisions with respect to the formulation of estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses. The following discusses such accounting policies and is included in the MD&A to assist the reader in assessing our critical accounting policies and practices and the likelihood of materially different results being reported. As management we review estimates regularly. The emergence of new information and changed circumstances, including accounting standards, may result in actual results or changes to estimated amounts that differ materially from current estimates.

RESERVES DETERMINATION

The petroleum and natural gas reserves used in determining our depletion rates and the ceiling test are based upon management's best estimates, and are subject to uncertainty. Through the use of geological, geophysical and engineering data, the reservoirs and deposits of petroleum and natural gas are examined to determine quantities available for future production, given existing operating and economic conditions and technology. The evaluation of recoverable reserves is an ongoing process impacted by current production, continuing development activities and changing economic conditions as reflected in crude oil and natural gas prices and costs. Consequently, the reserves are estimates which are subject to variability. We employ the services of independent oil and gas reservoir engineers to assist with the reserve evaluation process.

FULL COST ACCOUNTING FOR OIL AND GAS ACTIVITIES

Rally Energy uses the full cost method of accounting for exploration and development activities. In accordance with this method of accounting, all costs associated with exploration and development, are capitalized whether successful or not. The aggregate of net capitalized costs and estimated future development costs less estimated salvage values is amortized using the unit-of-production method based on estimated proved oil and gas reserves before royalties as determined by qualified independent petroleum evaluation engineers. Accordingly, changes in estimated proved oil and gas reserves and estimated future development costs would result in changes to the depletion rate.

Certain costs related to unproved properties and major development projects may be excluded from costs subject to depletion until proved reserves have been determined or their value is impaired. These properties are assessed periodically and any impairment is transferred to the costs subject to depletion.

IMPAIRMENT OF LONG-LIVED ASSETS

The Corporation reviews the carrying value of all property, plant and equipment, including the carrying value of oil and gas assets, for potential impairment. Impairment is indicated if the carrying value of the long-lived asset is not recoverable by the future undiscounted cash flows. In the event of impairment, the amount by which the carrying value exceeds the estimated fair value of the long-lived asset is charged to earnings.

LEGAL, ENVIRONMENTAL REMEDIATION AND OTHER CONTINGENT MATTERS

Rally Energy is required to both determine whether a loss is probable based on judgment and interpretation of laws and regulations and determine that the loss reasonably be estimated. Management continually monitors known and potential contingent matters and makes appropriate provisions by charges to earnings when warranted by circumstance.

INCOME TAX ACCOUNTING

The determination of the Corporation's income and other tax liabilities requires interpretation of complex laws and regulations often involving multiple jurisdictions. All tax filings are subject to audit and potential reassessment after the lapse of considerable time. Accordingly, the actual income tax liability may differ significantly from that estimated and recorded by management.

CHANGES IN ACCOUNTING STANDARDS

The Canadian Institute of Chartered Accountants (CICA) implemented several changes to accounting standards over the past year. A summary of changes, adoption time-frame and the effect on Rally Energy is summarized below.

ACCOUNTING POLICIES ADOPTED IN 2003 Stock-Based Compensation

In September 2003, CICA issued an amendment to section 3870, "Stock-based Compensation and Other Stock-based Payments", requiring that all stock options granted be fair valued and expensed accordingly.

The Corporation had early adopted, effective January 1, 2002, this new accounting standard, as it pertains to options granted to consultants. During the fourth quarter of 2003, we retroactively to the beginning of 2003, adopted the requirements to include options granted to employees, officers, and directors. Under this standard, compensation cost attributable to all stock options granted is measured at

fair value at the grant date and expensed over the vesting period with a corresponding increase to contributed surplus. Upon exercise of options, consideration received together with the amount previously recognized in contributed surplus is recorded as an increase to share capital. The impact of the adoption of this amended standard is disclosed in Note 7 of the notes to consolidated financial statements.

Oil and Gas Accounting – Full Cost

CICA Accounting Guideline 16 "Oil and Gas Accounting – Full Cost" establishes new rules for assessing asset impairment and has been early adopted by the Corporation, effective December 31, 2003. Oil and gas assets are evaluated in each reporting period to determine that the costs are recoverable and do not exceed the fair value of the properties. The guideline utilizes a ceiling test which incorporates expected future prices and costs in the determination of future cash flows as opposed to the current criteria of using constant year-end prices and costs. This guideline is effective for fiscal years beginning on or after January 1, 2004. At December 31, 2003 no ceiling test write-down was required for the Egypt properties, since the impairment test was met. Upon review of the Pakistan project, management has recorded an impairment with respect to the historical costs incurred. The PEI properties are still in the pre-production stage and, as such, are currently exempt from the impairment test.

NEW STANDARDS TO BE ADOPTED IN 2004 Asset Retirement Obligations

Effective January 1, 2004, the Corporation will adopt CICA Section 3110, "Accounting for Asset Retirement Obligations", requiring the fair value of asset retirement obligations to be recorded when they are incurred rather than merely accumulated or accrued over the useful life of the respective asset. Pursuant to S.3110, the fair value of the future retirement obligation is discounted to present value and is recorded as an increase to the related property, plant and

equipment with the corresponding balance recorded as a future asset retirement obligation. The increased asset value is amortized according to our policies for property, plant and equipment and the future liability is accreted to expense until the future retirement obligation is expected to be settled.

Continuous Disclosure Obligations

Effective March 31, 2004, all reporting issuers in Canada will be subject to new disclosure requirements according to National Instrument 51-102 "Continuous Disclosure Obligations". This new instrument is effective for fiscal years beginning on or after January 1, 2004. The instrument proposes shorter reporting periods for filing of annual and interim financial statements, MD&A and the AIF. Enhanced disclosure will also be required in the annual and interim financial statements, MD&A and AIF. Under this new instrument, the mailing of annual and interim financial statements and MD&A to shareholders will no longer be mandatory. The documents will be provided on an "as requested" basis and will be available on a continuous basis on our website (www.rallyenergy.com).

2004 OUTLOOK

Based on an extensive technical review of the Issaran oilfield completed in the fourth quarter of 2003, Rally Energy has embarked on a conventional drilling program aimed at

enhancing production levels in Egypt. Extensive reservoir modeling in 2003 has indicated that an estimated 24% or more of the 350+ million barrels of oil in place in the Upper Dolomite formation can be recovered economically using thermal recovery methods. As a result, the Corporation also intends to proceed with a three well steam pilot program. During 2004, funds will be spent to further upgrade Issaran infrastructure, to centralize well production facilities, upgrade field electrification and prepare the operations to handle higher production levels.

On PEI, new seismic and the results of a high resolution airborne gravity and magnetic survey completed during the fourth quarter of 2003 have identified additional drilling opportunities. A full re-evaluation of Rally Energy's PEI strategy is underway.

As a result of the recently announced business transaction regarding our Safed Koh Concession in Pakistan, Rally Energy will, subject to Pakistan government approval and closing, maintain a 22.5% partially carried interest in the ongoing exploration program. Subsequent to the transaction closing the Corporation will not have any ongoing capital commitments in respect to this Concession, unless gross program costs exceed US\$2.2 million.



MANAGEMENT'S REPORT

The accompanying Consolidated Financial Statements and all other information presented in the Annual Report are the responsibility of the Corporation's management. The Management's Discussion and Analysis of financial condition and Operations Review is reflective of management's views of the industry environment, current and future trends, and their effect on the Corporation's December 31, 2003 Financial Statements and future results.

The Consolidated Financial Statements have been prepared by management in accordance with Canadian generally accepted accounting principles. The Corporation's internal controls have been designed and maintained by management to provide reasonable assurance that assets are properly safeguarded, and that the financial records are sufficiently well-maintained to provide relevant, timely and reliable information to management and to allow preparation of the Consolidated Financial Statements in accordance with the Corporation's accounting policies. Certain estimates are made by management in the preparation of the Consolidated Financial Statements. In the opinion of management, the Consolidated Financial Statements have been prepared within reasonable limits of materiality, and within the framework of the significant accounting policies as summarized in the Notes to the Consolidated Financial Statements.

The Board of Directors exercises its responsibilities for financial controls through the Audit Committee, consisting of independent directors, which meets with management and the external auditors to satisfy itself that the responsibilities of the respective parties are properly discharged. The Consolidated Financial Statements have been approved by the Board of Directors on the recommendation of the Audit Committee.

BDO Dunwoody LLP, an independent firm of chartered accountants, has been appointed by the Shareholders to examine the Consolidated Financial Statements and to report to the Shareholders.



John G. F. McLeod, P. Eng.
President and
Chief Executive Officer

Douglas C. Urch, B.Comm., CMA
Vice President, Finance and
Chief Financial Officer

May 14, 2004

AUDITORS' REPORT

TO THE SHAREHOLDERS OF RALLY ENERGY CORP.

We have audited the consolidated balance sheets of Rally Energy Corp. as at December 31, 2003 and 2002 and the consolidated statements of operations and deficit and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Corporation as at December 31, 2003 and 2002 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

BDO Dunwoody LLP

Chartered Accountants

Calgary, Alberta
March 26, 2004

(except for Note 14(b), which is dated April 30, 2004)

RALLY ENERGY CORP.
CONSOLIDATED BALANCE SHEETS

As at December 31	2003	2002
ASSETS		
CURRENT		
Cash	\$ 2,260,426	\$ 1,811,851
Restricted cash (Note 4)	—	872,413
Accounts receivable	2,517,742	1,692,666
Cash calls receivable	—	936,015
Inventory	385,884	431,966
Prepaid expenses and deposits	244,727	314,717
Marketable securities (market value of \$28,130 (2002 - \$1,871))	32,304	1,871
	5,441,083	6,061,499
PROPERTY, PLANT AND EQUIPMENT (NOTE 5)	28,831,304	23,359,852
DEFERRED CHARGES (NOTE 6)	359,106	—
	\$ 34,631,493	\$ 29,421,351
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT		
Accounts payable – trade	\$ 2,388,787	\$ 3,036,598
Accounts payable – capital	2,521,000	1,880,850
Cash calls payable	—	936,015
Large corporation tax payable	32,000	—
	4,941,787	5,853,463
CONVERTIBLE DEBENTURES (NOTE 6)	5,640,810	450,000
SITE RESTORATION LIABILITY	66,000	—
	10,648,597	6,303,463
SHAREHOLDERS' EQUITY		
Equity instruments (Note 7)	35,562,644	29,588,971
Stock compensation	157,739	37,230
Deficit	(11,737,487)	(6,508,313)
	23,982,896	23,117,888
	\$ 34,631,493	\$ 29,421,351

On behalf of the Board:



Blair Coady
Director



John G.F. McLeod
Director

The accompanying notes are an integral part of these consolidated financial statements.

RALLY ENERGY CORP.
CONSOLIDATED STATEMENTS OF OPERATIONS AND DEFICIT

For the years ended December 31	2003	2002
OIL AND GAS REVENUE	\$ 11,238,328	\$ 3,497,179
Less: Royalties and related credits	(2,340,836)	(925,336)
	8,897,492	2,571,843
Operating expenses	3,224,909	1,159,629
NETBACK FROM OIL AND GAS OPERATIONS	5,672,583	1,412,214
EXPENSES		
Administrative expenses:		
Legal, professional and audit	391,739	279,148
Shareholder reporting and communication	334,184	89,100
Administration	2,299,491	1,561,949
Bad debts	15,386	32,535
	3,040,800	1,962,732
Interest expense	502,418	50,231
Depletion, amortization and site restoration	6,144,184	1,820,032
Write-down of petroleum and natural gas properties (Note 10(e))	1,210,825	—
Accretion expense on convertible notes	77,810	—
Amortization of deferred charge	77,805	—
	11,053,842	3,832,995
INCOME (LOSS) BEFORE UNDER NOTED ITEMS	(5,381,259)	(2,420,781)
OTHER ITEMS		
Interest income	92,231	35,617
Gain on foreign exchange	91,854	64
	184,085	35,681
INCOME TAXES		
Large corporation tax	32,000	—
EARNINGS (LOSS) FOR THE YEAR	(5,229,174)	(2,385,100)
DEFICIT, BEGINNING OF YEAR	(6,508,313)	(4,123,213)
DEFICIT, END OF YEAR	\$ (11,737,487)	\$ (6,508,313)
EARNINGS (LOSS) PER SHARE (NOTE 7(B))	\$ (0.09)	\$ (0.08)

Diluted loss per share has not been disclosed as such would be anti-dilutive.

The accompanying notes are an integral part of these consolidated financial statements.

RALLY ENERGY CORP.

CONSOLIDATED STATEMENTS OF CASH FLOWS

For the years ended December 31	2003	2002
CASH FLOWS FROM OPERATING ACTIVITIES		
Earnings (loss) for the year	\$ (5,229,174)	\$ (2,385,100)
Non-cash items:		
Stock compensation expense	120,509	37,230
Accretion expense on convertible notes	77,810	—
Amortization of deferred charges	77,805	—
Depletion, amortization and site restoration	6,144,184	1,820,032
Write-down of petroleum and natural gas properties (Note 10(e))	1,210,825	—
Cash flow (deficiency) from operations	2,401,959	(527,838)
Changes in non-cash working capital balances		
Accounts receivable	952,919	(918,295)
Inventory	(304,798)	(165,232)
Prepaid expenses and deposits	69,990	(133,381)
Accounts payable	(1,583,826)	2,365,628
Large corporation tax payable	32,000	—
	1,568,244	620,882
CASH FLOWS FROM INVESTING ACTIVITIES		
Oil and gas assets, net	(12,409,581)	(7,243,912)
Corporate acquisition (Note 3)	—	(1,601,621)
Changes in non-cash working capital	640,150	—
	(11,769,431)	(8,845,533)
CASH FLOWS FROM FINANCING ACTIVITIES		
Issuance of equity instruments, net	5,074,421	9,892,679
Convertible notes issued, net (Note 6)	5,575,341	—
Notes payable reduction	—	(475,523)
	10,649,762	9,417,156
INCREASE IN CASH	448,575	1,192,505
CASH, BEGINNING OF THE YEAR	1,811,851	619,346
CASH, END OF THE YEAR	\$ 2,260,426	\$ 1,811,851
SUPPLEMENTARY INFORMATION:		
Interest paid	\$ 104,483	\$ 22,985

The accompanying notes are an integral part of these consolidated financial statements.

December 31, 2003 and 2002

1. NATURE OF OPERATIONS

Rally Energy Corp. (the "Corporation") was incorporated on June 30, 1989 pursuant to the Ontario Business Corporations Act. Since inception, the Corporation's efforts have been devoted to the acquisition, exploration, and development of oil and gas properties.

Effective July 11, 2002, the Corporation completed the acquisition of Scimitar Hydrocarbons Corporation ("Scimitar") which has oil and gas properties in Egypt and Pakistan. The properties in Egypt are in production while the properties in Pakistan had not earned significant revenues and were considered to be in the pre-production stage. Effective December 31, 2003, the Corporation wrote-down the carrying value of its investment in the Pakistan properties as detailed in Note 10(e).

The consolidated financial statements have been prepared on the going concern basis, which contemplates the realization of assets and the satisfaction of liabilities and commitments in the normal course of business.

The Corporation's ability to continue as a going concern is dependent upon it continuing to generate sufficient cash flow from operations and/or raising additional financing to meet its commitments, current and planned. If the Corporation is unable to continue as a going concern, the net carrying value of its assets may be materially less than the carrying amount stated in the balance sheet and its liabilities extinguished at values different than those stated in the balance sheet.

The recoverability of amounts shown for oil and gas assets are dependent upon the discovery of economically recoverable reserves, continued confirmation of the Corporation's interest in the underlying concessions and the ability of the Corporation to obtain the necessary financing to complete the development and future profitable production or to receive proceeds from the disposition and/or exploitation of oil and gas properties.

2. SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements of the Corporation have been prepared by management in accordance with generally accepted accounting principles in Canada. The preparation of consolidated financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates. The consolidated financial statements have, in management's opinion, been properly prepared using careful judgment with reasonable limits of materiality and within the framework of the significant accounting policies summarized below.

(a) Principles of consolidation

The consolidated financial statements include the accounts of the Corporation and its wholly-owned subsidiaries, including Scimitar and its wholly-owned subsidiaries, acquired on July 11, 2002.

(b) Prepaids and deposits

Prepaids and deposits consist of rental deposits and prepaid expenses.

(c) Property, plant and equipment

The Corporation follows the Canadian Institute of Chartered Accountants' Accounting Guideline (AcG) – 16 for the full-cost method of accounting for oil and gas activities whereby all costs associated with the acquisition of, exploration for, and the development of oil and gas reserves are capitalized. In 2002 and 2003, these costs were capitalized in three cost centres, Canada, Egypt and Pakistan. Such costs include lease acquisitions, geological and geophysical expenditures, lease rentals on non-producing properties, drilling, equipment, and technical consulting directly related to exploration and development activities. Effective December 31, 2003, the Corporation wrote-down the carrying value of its investment in Pakistan (Note 10(e)). General and administrative costs including interest, unless directly related to exploration and development activities, are expensed. Proceeds from sales of oil and gas properties are recorded as reductions of capitalized costs unless the reduction of capitalized costs results in a change of 20% or more in the depletion rate. In this case, a gain or loss would be recognized into income.

RALLY ENERGY CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2003 and 2002

2. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

(c) Property, plant and equipment (continued)

For producing segments, the Corporation applies an impairment test ("ceiling test") to determine if capitalized costs are not recoverable and exceed their fair value. Capitalized costs are not recoverable if they are greater than estimated undiscounted cash flows from future production of proved and probable reserves plus the cost (net of impairment) of unproved properties. Commodity prices used in calculating estimated cash inflows are based on quoted benchmark prices in the futures market. Costs used in estimating cash outflows are based on expected future production and other costs and include abandonment and site restoration costs. An impairment loss is recognized if capitalized costs are greater than their recoverable amount. The impairment loss is measured as the amount by which capitalized costs exceed the fair value of proved and probable reserves plus the cost (net of impairment) of unproved properties. Fair value is determined based on the present value of future cash flows, after deducting abandonment and site restoration costs, discounted at a risk free interest rate, adjusted for prevailing market conditions. Any reduction of value, as a result of the ceiling test, will be charged to operations.

For non-producing segments, no impairment test was performed as all of the acquisition, development and exploration expenditures that have been incurred in the last 24 months and the results to December 31, 2003 are encouraging. No non-producing segments have been abandoned.

Depletion of petroleum and natural gas properties and amortization of well equipment is provided on the unit-of-production method based on proved petroleum and natural gas reserves. Natural gas is converted to equivalent units of petroleum products and reserves at approximately six thousand cubic feet to one barrel of oil.

Costs of acquiring and evaluating unproved properties are initially excluded from depletion calculations. These unevaluated properties are assessed periodically to ascertain whether impairment has occurred. When reserves are assigned or the property is considered to be impaired, the cost of the property or the amount of the impairment is added to costs subject to depletion calculations.

Capital assets are recorded at cost. Amortization is provided using a straight-line basis at rates expected to write off the carrying values, net of expected future recoveries, over the estimated useful lives of the assets.

(d) Joint ventures

The Corporation's Canadian activities are conducted jointly with others. These consolidated financial statements reflect only the Corporation's participating share of revenue and expenditures on these oil and gas interests.

(e) Income taxes

The Corporation follows the liability method of accounting for income taxes. Under this method, the Corporation records future income taxes for the effect of any difference between the accounting and income tax basis of an asset or liability, using the substantively enacted income tax rates. Accumulated future income tax balances are adjusted to reflect changes in income tax rates that are substantively enacted with the adjustment being recognized in earnings in the period that the change occurs.

(f) Marketable securities

Marketable securities are carried at the lower of cost or market value.

(g) Flow-through equity instruments

Expenditure deductions for income tax purposes related to exploratory activities funded by flow-through share arrangements are renounced to investors in accordance with income tax legislation. The Corporation provides for the future effect on income taxes related to flow-through shares as a charge to share capital when the expenditures are incurred. No liability regarding future taxes is recorded on unexpended flow-through share capital.

RALLY ENERGY CORP.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2003 and 2002

2. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

(h) Revenue recognition and inventory

In Egypt revenue is recognized upon delivery and acceptance of oil and is based on an agreed upon formula with The General Petroleum Co. S.A.E. ("GPC"). As is normal to the industry, the Corporation's oil production in Egypt is subject to royalties. Royalties deducted for 2003 averaged 20% (2002 – 22%) calculated at 15% of new well production and 45% of production from old wells.

Inventory is valued at the lower of weighted average cost or market value.

(i) Stock-based compensation

The Corporation has a stock-based compensation plan as described in Note 7. In September 2003, the CICA issued an amendment to section 3870 "Stock-based compensation and other stock-based payments." The amended section is effective for fiscal years beginning on or after January 1, 2004. The amendment requires that companies measure all stock-based payments using the fair value method of accounting and recognize the compensation expense in their financial statements. The Corporation implemented this amended standard in 2003 in accordance with the early adoption provisions of the standard. Per the transitional provisions, early adoption requires that compensation expense be calculated and recorded in the income statement for options and issued on or after January 1, 2003. The fair value is measured at the grant date and charged to earnings over the vesting period with a corresponding increase in contributed surplus. Consideration paid on exercise of options is credited to share capital. None of the Corporation's awards call for settlement in cash or other assets.

Prior to January 1, 2003, the Corporation did not record expenses for options issued to employees, officers, and directors. Consideration paid by employees or directors on the exercise of stock options under the option plan were recorded as share capital. The Corporation did apply the fair value method to stock options granted to non-employees resulting in recognition of an expense with a corresponding credit to shareholders' equity.

(j) Per share amounts

The earnings per share figures have been calculated using the weighted average number of common shares outstanding during the periods. Diluted per share amounts reflect the potential dilution that could occur if securities or other contracts to issue common shares were exercised or converted to common shares. The treasury stock method is used to determine the dilutive effect of stock options and other dilutive instruments. Diluted earnings per share have not been disclosed as such would be anti-dilutive or have an immaterial difference.

(k) Financial instruments

The Corporation carries a number of financial instruments. It is management's opinion that the Corporation is not exposed to significant interest, currency or credit risks arising from these financial instruments. The fair values of these financial instruments approximate their carrying values, unless otherwise noted.

(l) Foreign currency

Foreign currency accounts of the Corporation are translated into Canadian funds as follows:

- ☐ Monetary assets and liabilities are translated at period end exchange rates. Non-monetary items are translated at exchange rates prevailing at the date of acquisition.
- ☐ Revenue and expense items are translated at the average exchange rate for the period.
- ☐ Realized and unrealized foreign exchange gains and losses are included in operations.

RALLY ENERGY CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2003 and 2002

2. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

(l) **Foreign currency (continued)**

Foreign currency balances of foreign subsidiaries are translated using the temporal method for integrated operations on the following basis:

- ☐ Monetary assets and liabilities are translated at the rates of exchange prevailing at the balance sheet dates.
- ☐ Non-monetary assets, liabilities and related amortization expense are translated at historical rates.
- ☐ Sales, other revenue, royalties and all other expenses are translated at the average rate of exchange during the month in which they are recognized.
- ☐ Amortization of assets translated at historical exchange rates are translated at the same rates as the assets to which they relate.

(m) **Measurement uncertainty**

The amounts recorded for depletion and amortization of property, plant and equipment and the provision for site restoration and reclamation are based on estimates. The ceiling test is based on estimates of proved reserves, production rates, oil and gas prices, future costs and other relevant assumptions. By their nature, these estimates are subject to measurement uncertainty and the effect on the financial statements of changes and estimates in future periods could be significant.

The financial statements include accruals based on the terms of existing joint venture agreements. Due to varying interpretations of the definition of terms in these agreements the accruals made by management in this regard may be significantly different from those determined by the Corporation's joint venture partners. The effect on the financial statements resulting from such adjustments, if any, will be reflected prospectively.

(n) **Cash**

Cash consists of cash on hand and bank balances.

3. BUSINESS ACQUISITION

The acquisition of Scimitar has been accounted for by the purchase method effective July 11, 2002, based on the carrying values of the assets or liabilities of Scimitar which approximate the fair values as follows:

Current assets, including cash of \$48,725	\$ 1,827,012
Cash on deposit	840,339
Property, plant and equipment	11,481,922
Accounts payable	(2,970,503)
Convertible debentures	(450,000)
Net identifiable assets acquired, attributed to shares issued	<u>\$ 10,728,770</u>
Value attributed to 22,309,219 shares issued at \$0.50 per share	\$ 11,154,610
Transaction costs	150,346
Cash advances	1,500,000
Payout of Scimitar options (36,200 shares issued)	18,100
Finders' fees	<u>725,000</u>
	<u>\$ 13,548,056</u>
Purchase price discrepancy, allocated to property, plant and equipment	<u>\$ 2,819,286</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2003 and 2002

4. RESTRICTED CASH

As at December 31, 2003 the restricted cash balance was \$nil.

At December 31, 2002, US\$553,000 (\$872,413 using December 31, 2002 exchange rates) was on deposit with the Royal Bank of Canada as security for a US\$553,000 bank guarantee issued to the Government of Pakistan. The bank guarantee was in respect of capital expenditures of US\$100,000 and US\$453,000 required in 2002 and 2003, respectively, by one of its wholly-owned subsidiaries, pursuant to the January 18, 2002 Concession Agreement (Note 10(d)). All obligations for 2002 and 2003 have been completed, the guarantee was released on March 27, 2003 and US\$553,000 cash was released to the Corporation.

5. PROPERTY, PLANT AND EQUIPMENT

The Corporation holds various working interests in developed and undeveloped oil and gas properties. The carrying amounts of these properties are as follows:

December 31, 2003	Cost	Accumulated Depletion, Amortization and Write-offs	Net Book Value
Petroleum and natural gas properties	\$ 36,315,997	\$ 8,650,944	\$ 27,665,053
Mining claims	1	—	1
Furniture, machinery and equipment	\$ 1,701,050	\$ 534,800	\$ 1,166,250
	<u>\$ 38,017,048</u>	<u>\$ 9,185,744</u>	<u>\$ 28,831,304</u>

December 31, 2002	Cost	Accumulated Depletion and Amortization	Net Book Value
Petroleum and natural gas properties	\$ 23,641,682	\$ 1,685,555	\$ 21,956,127
Mining claims	1	—	1
Furniture, machinery and equipment	1,548,436	144,712	1,403,724
	<u>\$ 25,190,119</u>	<u>\$ 1,830,267</u>	<u>\$ 23,359,852</u>

No ceiling test was completed in 2002 on the Egypt properties as these were recent acquisitions completed by the Corporation in 2002.

The expenditures deferred in Egypt are being depleted on a unit-of-production basis. These costs include exploration, drilling and equipping costs. All other capital expenditures are also capitalized under the terms of Scimitar Egypt's agreement with GPC. Scimitar Egypt has the right to explore and exploit the concession area for an initial term of 20 years (Note 10(d)) plus two additional five-year terms. The renewals are subject to GPC approval. The depletion factor used to deplete these assets is based on the production expected to be achieved over the next 9 years. At the end of each year, the ownership of all assets, tangibles and intangibles, reverts to GPC. It is intended that the deferred expenditures will be fully depleted by the end of the concession term, and that assets under lease will be either returned to lessors or re-leased to GPC.

No depletion has been recorded on the oil and gas properties for certain Canadian properties as significant production has not yet commenced. Once significant production commences, the Corporation will deplete on the unit-of-production method based on the estimated net proved reserves.

During the year ended December 31, 2003, the Corporation capitalized general and administrative expenditures in Canada of \$345,287 (2002 - \$297,056), which were included in the above amount. The Corporation did not capitalize any general and administrative expenditures on their Egypt properties.

For the Pakistan properties, general and administrative expenditures in the amount of \$426,749 (2002 - \$329,147) were capitalized in 2003 and the Corporation capitalized \$nil (2002 - \$18,491) of interest expenses. All of the capitalized expenditures with respect to the Pakistan properties as at December 31, 2003, were written-down in 2003 (Note 10(e)).

RALLY ENERGY CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2003 and 2002

5. PROPERTY, PLANT AND EQUIPMENT (CONTINUED)

At December 31, 2003, the Corporation held \$1,149,713 of drill pipe inventory available for future capital expenditures in the Issaran oilfield in Egypt. This amount is included in Property, Plant and Equipment.

The mining claims represent a 35.3% undivided interest in 20-patented mining claims and 10 mining leases located in Cunningham Township, Province of Ontario. The claims were being carried at the nominal value of \$1.

An impairment calculation was performed on the Corporation's property, plant and equipment at December 31, 2003 in which the estimated undiscounted future net cash flows associated with the proved and probable reserves exceeded the carrying amount of the Corporation's property, plant and equipment. A similar test performed at January 1, 2003 upon adoption of AcG - 16 also resulted in a surplus.

The following table outlines benchmark prices used in the impairment test at December 31, 2003:

Year	Brent Crude Oil US\$/bbl	Issaran Wellhead Cdn\$/bbl
2004	24.33	20.27
2005	22.25	19.60
2006	21.47	19.76
2007	21.82	20.37
2008	22.18	20.70
Thereafter (inflation %)	4%	4%

6. CONVERTIBLE DEBENTURES

On June 13, 2003, the Corporation issued \$6.0 million, 12% unsecured convertible subordinated debentures which are entitled to semi-annual interest payments and mature on July 1, 2006. The debentures are convertible, at the option of the holder, at any time prior to July 1, 2005, into common shares at a conversion price of \$1.00 per common share. After July 1, 2005, the conversion price increases to \$1.10 per common share. The debentures are not redeemable by the Corporation prior to January 1, 2005. Thereafter, the debentures are redeemable at par, in whole or in part, if the closing price of the Corporation's common shares are at or above \$2.00 for 30 consecutive trading days. An agent's commission of \$420,000 was paid in relation to debenture subscriptions. The legal fees and cash commissions incurred to secure the debenture financing are recorded as deferred charges and the related amortization charges have been included in interest and related charges.

As the convertible debentures are considered to be compound financial instruments, the principal amount has been allocated between liability and equity components, which are then classified separately on the balance sheet. The liability component has been determined using an interest rate for comparable debt instruments having no conversion rights. The difference between the liability component and the principal amount of the notes has been allocated to equity. The equity component is accreted over the term of the notes such that at maturity the liability will be equivalent to the principal amount.

The equity portion of the convertible note represents \$437,000 as determined using a Black-Scholes model. The fair value of share options was estimated using the Black-Scholes option-pricing model with the following assumptions: Dividend yield (Nil), volatility (0.18), risk-free interest rate (5.0%), and weighted average life of 1.5 years.

Amortization of the equity component is recognized in the statement of operations over the duration of the debt instrument as interest and related charges. The liability element is subsequently reported at amortized cost and the value of the equity conversion option is not changed in future periods.

As part of the 2002 Scimitar acquisition, certain directors of the Corporation, or companies related to them, subscribed for an aggregate \$450,000 principal amount of convertible subordinated debentures. The debentures bore interest at 12%, payable monthly, with maturity on July 10, 2004. During the first quarter of 2003, the debentures were fully converted into 584,415 common shares of the Corporation at a conversion price of \$0.77 per share.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2003 and 2002

7. EQUITY INSTRUMENTS

(a) Authorized

Unlimited number of Common Shares.

Unlimited number of Convertible Preference Shares, cumulative preferential dividend at the rate of \$0.06 per share per annum, redeemable by the Corporation.

(b) Issued and outstanding

	December 31, 2003		December 31, 2002	
	Number of Shares	Amounts	Number of Shares	Amounts
Common shares				
Balance, beginning of year	49,961,273	\$ 23,363,050	12,901,849	\$ 5,366,171
Stock options exercised	600,000	266,000	470,000	188,000
Special warrants exercised (Note 7(d), (e) and (g))	13,450,000	6,725,000	4,583,336	1,457,501
Private placement – unit subscription (Note 7(i))	2,941,177	2,435,097	–	–
Private placement – fee for services	20,000	16,200	–	–
Conversion of debentures (Note 6)	584,415	450,000	–	–
Purchase warrants exercised (Note 7(d))	–	–	2,016,669	806,668
Issued in conjunction with Scimitar acquisition (Note 3)	–	–	22,345,419	11,172,710
Special warrants exercised – flow-through shares (Note 7(f))	–	–	2,144,000	1,072,000
Private placement – flow-through shares (Note 7(h))	3,832,875	2,683,012	5,500,000	3,300,000
Tax effect on flow-through shares ⁽¹⁾	–	–	–	–
	<u>71,389,740</u>	<u>35,938,359</u>	<u>49,961,273</u>	<u>23,363,050</u>
Special warrants – common shares				
Balance, beginning of period	13,450,000	6,725,000	4,583,336	1,457,501
Exercised during the period (Note 7(d), (e) and (g))	(13,450,000)	(6,725,000)	(4,583,336)	(1,457,501)
Issued for cash (Note 7(d) and 7(h))	–	–	12,000,000	6,000,000
Issued in conjunction with Scimitar acquisition	–	–	1,450,000	725,000
	<u>–</u>	<u>–</u>	<u>13,450,000</u>	<u>6,725,000</u>
Special warrants – flow-through shares				
Balance, beginning of period	–	–	2,144,000	1,072,000
Issued for cash (Note 7(f))	–	–	(2,144,000)	(1,072,000)
	<u>–</u>	<u>–</u>	<u>–</u>	<u>–</u>
Subtotal, common stock equivalents	<u>71,389,740</u>	<u>35,938,359</u>	<u>63,411,273</u>	<u>30,088,050</u>
ADD: Equity portion of convertible debentures	–	437,000	–	–
LESS: Share issue costs	–	(777,618)	–	(355,079)
Balance, common stock equivalents	<u>71,389,740</u>	<u>35,597,741</u>	<u>63,411,273</u>	<u>29,732,971</u>
Share purchase warrants – common shares				
Issued during the period (Note 7(i))	<u>1,676,472</u>	<u>64,903</u>	<u>–</u>	<u>–</u>
	<u>1,676,472</u>	<u>64,903</u>	<u>–</u>	<u>–</u>
Less: share purchase loans (Note 8)	–	(100,000)	–	(144,000)
Balance, end of year, all equity instruments		<u>\$ 35,562,644</u>		<u>\$ 29,588,971</u>
Weighted average number of shares	<u>59,606,379</u>		<u>29,951,827</u>	

⁽¹⁾ The tax effect of the qualifying expenditures of \$1,428,750 has been offset by recognition of certain future tax assets available to the Corporation (Note 9). The Corporation is required to expend an additional qualifying expenditure of \$2,367,524 prior to December 31, 2004 to meet its commitments under the 2003 flow-through agreements.

⁽²⁾ Common stock equivalents include common shares issued and outstanding and special warrants issued that are convertible into common shares with no additional proceeds.

RALLY ENERGY CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2003 and 2002

7. EQUITY INSTRUMENTS (CONTINUED)

(c) Options

The shareholders of the Corporation approved a formal stock option plan under which directors, officers, employees and consultants are eligible to receive grants. Stock option agreements have vesting periods varying from immediate to three years and expiration terms vary from two to five years.

	December 31, 2003		December 31, 2002	
	Share Options	Weighted Average Exercise Price	Share Options	Weighted Average Exercise Price
Outstanding, beginning of year	5,903,500	\$0.56	1,370,000	\$0.40
Granted	1,476,000	\$0.79	5,003,500	\$0.59
Exercised	(600,000)	\$0.44	(470,000)	\$0.40
Cancelled	(316,970)	\$0.63	—	—
Outstanding, end of year	6,462,530	\$0.62	5,903,500	\$0.56

Options Outstanding						
Exercise Price	December 31, 2003			December 31, 2002		
	Number of Options		Weighted Average Years to Expiry	Number of Options		Weighted Average Years to Expiry
	Outstanding	Exercisable		Outstanding	Exercisable	
\$0.40	560,000	560,000	0.52	900,000	900,000	1.54
\$0.50	625,000	625,000	1.25	885,000	885,000	2.25
\$0.55	151,500	151,500	0.75	151,500	151,500	1.75
\$0.60	3,555,333	2,961,339	3.52	3,842,000	1,892,341	4.76
\$0.61	786,000	262,005	4.83	—	—	—
\$0.80	365,000	365,000	3.04	—	—	—
\$0.88	94,697	94,697	2.25	125,000	83,333	3.25
\$1.22	325,000	108,337	4.17	—	—	—
	6,462,530	5,127,878	3.90	5,903,500	3,912,174	3.08

The Corporation recorded \$120,509 for options issued in 2003 (2002 – 37,230). The fair value of share options was estimated using the Black-Scholes option-pricing model with the following assumptions: dividend yield (nil) (2002 – nil), volatility (0.18) (2002 - 0.13), risk-free interest rate (5.0%) (2002 – 5.0%), and weighted average life of 5 years (2002 - 4.25 years).

(d) Special warrants

The Corporation issued 4,033,336 special warrants at \$0.30 each in 2002. Each special warrant is exercisable into 4,033,336 common shares and 2,016,669 share purchase warrants. Each share purchase warrant entitled the holder to acquire an additional common share at \$0.40 per share for a period of one year from the date of their issuance, expiring on August 14, 2002. On April 1, 2002 these special warrants were exercised and the 2,016,669 additional share purchase warrants issued were exercised on August 14, 2002 at \$0.40 per share.

(e) Special warrants – common shares

The Corporation issued 550,000 special warrants for common shares at \$0.45 each in 2001. Each special warrant is exercisable into 550,000 common shares at no additional cost, expiring on November 15, 2002. On April 1, 2002 these special warrants were exercised.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2003 and 2002

7. EQUITY INSTRUMENTS (CONTINUED)

(f) **Special warrants – flow-through shares**

The Corporation issued 2,144,000 special warrants for flow-through shares in 2001. Each special warrant is exercisable into 2,144,000 flow-through shares, expiring on November 15, 2002. On April 1, 2002 these special warrants were exercised.

(g) **Special warrants – common shares**

On June 28, 2002, the Corporation completed a private placement of \$6,000,000 and issued 12,000,000 special warrants. On July 10, 2002, the Corporation issued 1,450,000 special warrants, at a deemed value of \$0.50 per special warrant, as aggregate finders' fees related to the acquisition of Scimitar. In accordance with the special warrant terms, all 13,450,000 special warrants were converted into common shares, on a one-for-one basis, on June 28, 2003 at no additional cost.

(h) **Private placement – flow-through common shares**

On December 19, 2003 the Corporation completed a private placement of 3,832,875 common shares issued on a flow-through basis at a price of \$0.70 per share.

On December 31, 2002, the Corporation completed a private placement of 5,500,000 common shares issued on a flow-through basis at a price of \$0.60 per share.

(i) **Private placement – common shares and purchase warrants**

On June 13, 2003, the Corporation issued 2,941,117 units priced at \$0.85 per unit for gross proceeds of \$2,500,000. Each unit consists of one common share and one-half of a common share purchase warrant. Each full warrant is exercisable for \$1.00 per common share on or before December 31, 2004. A value of \$64,903 has been attributed to these warrants. An agent's commission of \$174,000 was paid in relation to unit subscriptions. In addition, 205,882 common share purchase warrants were issued to the agent. No value has been attributed to these warrants as such was immaterial. Agent's warrants are exercisable for \$1.00 per common share on or before December 31, 2004.

8. RELATED PARTY TRANSACTIONS

- (a) Except as noted elsewhere in these financial statements, the Corporation was involved in the following related party transactions:

	<u>December 31, 2003</u>	<u>December 31, 2002</u>
Consulting fees paid to companies, whose shareholders are directors and officers of the Corporation:		
Included in general and administrative expenses	\$ 689,600	\$ 383,000
Capitalized (Note 5)	\$ 371,500	\$ 163,000

- (b) During 2002, the Corporation advanced funds totaling \$120,000 to certain directors and officers to purchase shares in the Corporation at \$0.50 per share. The balance bears interest at prime plus one percent and is due on June 30, 2004. The amount is represented by unsecured promissory notes. In December 2003, \$20,000 plus accumulated interest, was repaid.
- (c) Also in 2002, the Corporation had a receivable for \$24,000 to acquire an aggregate of 60,000 shares pursuant to exercise of options. The amount was paid in January 2003.
- (d) Two officers of the Corporation purchased \$42,000 of the June 2003 unit offering described in Note 7(i).

The above (a) and (b) transactions occurred in the normal course of business operations and represent consideration established and agreed to by the related parties which is similar to those negotiated with third parties.

RALLY ENERGY CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2003 and 2002

9. INCOME TAXES

The provision for income taxes differs from the amount obtained by applying the combined Federal and Provincial income tax rates to income before income taxes. The difference relates to the following items:

	<u>December 31, 2003</u>	<u>December 31, 2002</u>
Income (loss) before income taxes	\$ (5,229,174)	\$ (2,385,100)
Corporate tax rate	39.5%	39.5%
Expected income tax recovery	(2,065,523)	(942,115)
Stock compensation	120,509	14,706
Canadian resource related items	197,775	—
Valuation allowance	1,747,239	927,409
	<u>\$ —</u>	<u>\$ —</u>

At December 31, 2003 the Corporation has exploration and development expenditures (direct and successored) and undepreciated capital costs totaling \$8,551,000 which may be carried forward indefinitely to reduce future Canadian taxable income:

Canadian oil and gas property expenses (COGPE)	\$ 4,529,000
Canadian development expenses (CDE)	1,391,000
Canadian exploration expenses (CEE)	2,185,000
Undepreciated capital costs	<u>446,000</u>
	<u>\$ 8,551,000</u>

The future tax asset from the above tax pools has not been recorded as it is likely that some, or all, of the future tax asset will not be realized. In future periods, to the extent that this asset is realizable, this amount will be recorded as an asset. \$1,428,750 (2002 - \$387,245) of the future tax asset was recognized in the current year to offset tax liability associated with qualifying expenditures incurred pursuant to the flow-through offerings completed in 2002 and 2003. The Corporation is committed to spending an additional \$2,367,524 in qualifying expenditures pursuant to a flow-through financing completed in 2003.

In addition, the Corporation has non-capital loss carry forwards in Canada for tax purposes. These losses are available to reduce future taxable income but, if not claimed, will expire as follows:

2004	\$ 647,000
2005	217,000
2006	209,000
2007	353,000
2008	1,156,000
2009	863,000
2010	<u>2,466,000</u>
	<u>\$ 5,911,000</u>

No future tax asset has been recorded for the excess of the Canadian tax pools compared to the carrying value of the Canadian assets as there is no assurance that these will be realized.

Under the terms of the Petroleum Service Agreement ("PSA") with GPC, the payment received on account of production in Egypt is not subject to income tax. All production in Egypt is subject to a royalty charge pursuant to the terms of the PSA, which satisfies all tax liabilities.

The tax pools available in Pakistan are currently not determinable.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2003 and 2002

10. COMMITMENTS

- (a) The Prince Edward Island permits carry an obligation to pay a 10% crown royalty on natural gas production to the Prince Edward Island government and a 2.5% gross overriding royalty to a third party. Prior to commencement of production, the Corporation will complete the necessary application to qualify for a crown royalty holiday provision. Seven of the eight leases will expire during 2004. The Corporation currently intends to continue with its PEI activities, however, a full re-evaluation of Rally Energy's PEI strategy is underway.
- (b) Pursuant to the flow-through common shares issued (Note 7(h)), the Corporation is committed to spending \$2,683,012 on qualified expenditures by December 31, 2004. As of December 31, 2003, the Corporation has expended \$315,488 on qualified expenditures.
- (c) A provision for environmental and site restoration costs is made when restoration requirements are established and costs can be reasonably estimated. The site restoration costs are accrued on the basis of actual production. The accrual is based on management's best estimate of the future costs in the amount of \$189,000 on the ratio of actual production to proved producing reserves.
- (d) A wholly-owned subsidiary of the Corporation entered into a PSA with GPC effective November 4, 1998, pursuant to which the Corporation is granted the exclusive right to develop and produce heavy oil from the Issaran, Egypt oilfield. On October 18, 2001, the Corporation entered the Commercial Development Period of the PSA, after having successfully satisfied the terms of the three-year Piloting Period. The Corporation has the option to extend the 20-year term of the PSA (commencing from November 4, 1998), for up to two additional five-year terms subject to concurrence with the GPC. The Commercial Development Period does not require any specific capital expenditure commitments. The GPC has also agreed that the subsidiary would also receive the following oil pricing until an amending notice is issued:
 - i) 90% of the Ras Gharib Export Blend Price if Brent is below US\$20 per barrel;
 - ii) 85% of the Ras Gharib Export Blend Price if Brent is between US\$20 and US\$22 per barrel;
and
 - iii) 80% of the Ras Gharib Export Blend Price if Brent is greater than US\$22 per barrel.
- (e) On November 10, 2001, an Exploration License over the Safed Koh Block in Pakistan was awarded to Scimitar Hydrocarbons Pakistan Ltd. ("SHPL") (subsequently renamed to Rally Energy Pakistan Ltd. in December 2002), a wholly-owned subsidiary of the corporation, and MESA Petroleum (Private) Limited, a Pakistani corporation, as to an 80% and 20% interest respectively. Pakistan Government policy required a minimum 20% local participation in the Exploration License. The corresponding Concession Agreement was finalized on January 18, 2002. SHPL has agreed to fund 100% (including MESA's share of such commitments) of the Phase I work commitments commencing January 18, 2002. The commitment during the evaluation period was to spend US \$573,000 (CDN \$918,201) to carry out certain activities, including a review of existing geological, geophysical and well data. The majority of these expenditures were completed by December 31, 2002. Subsequent to year-end, the Corporation indicated that it intends to participate on a partially carried interest basis in the Phase II exploration program. An arrangement has been negotiated whereby a new partner, as operator, will commit to future expenditures of up to \$US2.2 million. The Corporation will have a 22.5% carried interest for its share of up to the US\$2.2 million project expenditure commitment. The primary term of the license over the Block has expired and the Corporation has received conditional extensions. Due to the uncertainty surrounding the extension period and required commitments, the Corporation's management made the determination that the value of the Pakistan property should be accounted for as an impaired asset. Accordingly, a write-down of \$1,210,825 was recorded in the fourth quarter of 2003.
- (f) The Corporation rents premises under operating leases that require the following minimum payments:

2004	\$ 108,481
2005	108,481
2006	108,481

- (g) The Corporation is committed to paying \$2,500 per month for an investor relations contract until September 2004. This contract is cancelable upon a 30 day notice.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2003 and 2002

11. MAJOR CUSTOMERS

Substantially all of the Corporation's revenue for the year has been derived from a PSA with the GPC. Oil is currently marketed to the Egyptian General Petroleum Company, a company wholly-owned by the Arab Republic of Egypt.

12. SEGMENTED INFORMATION

The Corporation operates in the oil and gas industry. Its reportable segments are identified on a geographic basis.

Geographic Segments:

The Corporation has operations in Egypt, Pakistan and Canada. Gross revenue for the period ended and capital assets are summarized on a country basis below:

December 31, 2003	Egypt	Canada	Pakistan	Total
Gross revenue	\$ 11,199,664	\$ 38,664	\$ –	\$ 11,238,328
Property, plant and equipment	\$ 14,842,399	\$ 13,988,905	\$ –	\$ 28,831,304
December 31, 2002 (restated – Note 2(d))	Egypt *	Canada *	Pakistan *	Total
Gross revenue	\$ 3,482,978	\$ 14,201	\$ –	\$ 3,497,179
Property, plant and equipment	\$ 12,691,466	\$ 9,936,041	\$ 732,345	\$ 23,359,852

* On July 10, 2002 the Corporation completed the Plan of Arrangement with Scimitar and consequently, the Egypt and Pakistan activities reflect only the July 11, 2002 to December 31, 2002 period.

13. STOCK COMPENSATION

For options issued in 2002, the Corporation did not record compensation expense when stock options are issued to employees, as disclosed in Note 2(i).

Had compensation expense related to employees been determined based on the fair value at the grant dates, the net income and earnings per share would have been reduced to the pro forma amounts indicated below:

		2003	2002
Earnings (loss)	- as reported	\$ (5,229,174)	\$ (2,385,100)
	- pro forma	\$ (5,279,174)	\$ (2,866,817)
Earnings (loss) per share – basic and diluted			
	- as reported	\$ (0.09)	\$ (0.08)
	- pro forma	\$ (0.09)	\$ (0.10)

The fair value of share options was estimated using the Black-Scholes option-pricing model with the following assumptions: dividend yield (nil) (2002 - nil), volatility (0.13), risk-free interest rate (5.0%), and weighted average life of 4.25 years.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2003 and 2002

14. SUBSEQUENT EVENTS

- (a) Subsequent to year-end, the following changes have occurred with respect to the Corporation's stock options:

	# Options	\$ amount
Exercised on January 12, 2004	(33,333)	\$0.60
Cancelled on January 12, 2004	(60,606)	\$0.88
Cancelled on February 11, 2004	(325,000)	\$1.22
Net Change	(418,939)	

- (b) On April 30, 2004, the Corporation, through its wholly-owned subsidiary, Scimitar Production International Ltd., closed a US\$3.0 million unsecured project financing to fund further development of the Ras Issaran oilfield.

Under the terms of the Investment Agreement, the investor, Gemini Oil & Gas Limited, an independent international oil and gas investment fund, is entitled to revenue-based payments from the Ras Issaran oilfield commencing in 2005. The maximum revenue-based entitlement will be US\$1.5 million in each of 2005 and 2006 with no minimum payments required. Upon investment payout, and continuing until December 31, 2012, the investor is entitled to receive 2.6% of Ras Issaran oil revenues relating to production of up to 7,000 bbls/d, net of marketing fees and entitlements of the GPC.

15. FINANCIAL INSTRUMENTS

As disclosed in Note 2(m), the Corporation holds various forms of financial instruments. The nature of these instruments and the Corporation's operations expose the Corporation to industry credit risks. The Corporation manages its exposure to these risks by operating in a manner that minimizes its exposure to the extent practical.

(a) Credit risk

A significant portion of the Corporation's trade accounts receivable are from working interest partners in the oil and gas industry and, as such, the Corporation is exposed to all the risks associated with that industry. In addition, all of the trade receivables are from one Corporation. Due to this and the fact that majority of the Corporation's cash is held at one institution, the Corporation is exposed to concentrations on credit risk.

(b) Commodity price risk

The Corporation will be subject to commodity price risk for the delivery of natural gas and crude oil. As detailed in Note 10(d), the Corporation is subject to price limits on all of its current production.

Commodity price hedging may occur from time to time to protect the integrity of the Corporation's revenue stream.

(c) Foreign currency rate risk management

A significant portion of the Corporation operations are located outside of Canada and, accordingly, the related financial assets and liabilities are subject to fluctuations in exchange rates.

The Corporation manages its exposure to foreign currency fluctuations by maintaining foreign currency bank accounts and receivables to offset foreign currency payables and planned expenditures.

16. CONTINGENCIES

The Corporation is subject to various regulatory and statutory requirements relating to the protection of the environment. These requirements, in addition to contractual agreements and management decisions, result in the accrual of estimated future removal and site restoration costs. These costs are accrued on the unit-of-production basis. Any changes in these estimates will affect future earnings.

Costs attributable to these commitments and contingencies are expected to be incurred over an extended period of time and are to be funded mainly from the Corporation's cash provided by operating activities. Although the ultimate impact of these matters on net earnings cannot be determined at this time, it could be material for any one quarter or year.

17. COMPARATIVE FIGURES

Certain comparative figures have been reclassified to conform to the current period's financial statement presentation.

MANAGEMENT

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President and Chief Executive Officer

Douglas C. Urch, B.Comm., CMA
Vice President, Finance and Chief Financial Officer

Ron Johnston, B.Comm.
Vice President, Corporate Development

Ernest G. Pratt, M.Sc., P.Geol.
Vice President, Exploration

Mel Trethart, B.Sc. (Civil Engineering)
General Manager, Egyptian Operations

Richard W. Pawluk, LL.B.
Corporate Secretary

BOARD OF DIRECTORS

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- 1) Executive and Corporate Governance Committee
- 2) Audit Committee
- 3) Compensation Committee
- 4) Reserves Committee

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Calgary, Alberta

HSBC Bank Egypt
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REGISTRAR AND TRANSFER AGENT

Valiant Trust Company
Calgary, Alberta

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TSX Venture Exchange - Symbol "RAL"
Frankfurt Stock Exchange - Symbol "RLE"



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